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A Comparative Study of Takeover Defences in UK, US and Chinese Law

By Miao Liu

Thesis submitted in fulfillment of the requirement for the
award of Philosophy of Doctorate at Durham University

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Course of Argument

This thesis explores the issues regarding which regime style would be appropriate for China to adopt in the regulation of takeover defences, given that there are two distinct takeover regulatory systems in the world – that of the UK, and that of the US. China has already adopted a UK-style shareholder-friendly regulatory system. This thesis considers the reasons why China has chosen a shareholder-friendly takeover regulatory system rather than a US-style director-friendly regulatory system. In addition, combining analysis of the character of China's market and its legal framework, it discusses whether the current regulatory system is appropriate for China or not. Furthermore, it considers specific features of individual takeover defensive tactics and the possibility of their use being legitimised in China.

This thesis is relevant because of the likelihood of the freeing up of the Chinese takeover market in the future; as this happens, there will be more and more takeover activity, taking place in China's market. Thus it is important to provide adequate legislation for market players. Though China adopted the UK's shareholder regulatory system many years ago, when it first regulated its takeover market, the shareholding structure in China is totally different to the UK's, and so it is important to discuss whether this regulatory system is still relevant for China or whether there should be a change to a regulatory system more like that of the US. As China issued the Administrative Measures of Preferred Shares Experimental Units in 2014, and the new leadership in China has continued China's economic reform over recent years, it

could be said that China's listed companies have become more attractive to investors and there could be more hostile raiders entering the market. Hence there is a need to consider whether China's delegation of decision-making powers to the shareholders regarding defence against hostile raiders is appropriate. It is also important to establish which takeover defence measures might appropriately be legalised and which would be inappropriate for China.

Chapter 1 introduces background information about the trend of mergers and acquisitions and hostile takeovers, China's state-owned enterprises and briefly consider takeover defensive measures. Following this, it discusses shareholding structures, and problems in China's market in comparison with the UK and US.

Chapter 2 outlines both the UK's and US's distinctive takeover regulatory systems and evaluates their pros and cons, as well as the reasons why certain regulatory systems are suitable for each market.

Chapter 3 explores the differences between China's ownership structure, market, and legal framework, and those of the UK and US. It also summarises the weaknesses of the Chinese system(s) in seeking to transplant a western-style set of takeover regulations into China's market. Primarily, these are that (a) China does not provide sufficient legislation relating to takeover defence measures and (b) Chinese market players and legal advisors do not have adequate experience of takeover defence measures.

Chapter 4 discusses takeover defence measures related to stock trading – share repurchase, the ‘pac-man’ defence, the use of white knights and ESOP. The chapter concludes that the first two tactics may be too risky for target companies such that their adoption should be prohibited in China while the latter two tactics may be helpful and could be widely used by China’s listed companies.

Chapter 5 considers takeover defence measures related to management, such as poison pills, shark repellents, the scorched earth policy, dual class recapitalization and three kinds of parachutes. Except for the scorched earth policy, which could be harmful to the long-term interests of target companies, the other tactics may work well in China’s market and help Chinese companies secure controlling power or raise the share premium.

Chapter 6 looks into defensive measures relating to litigation, raising anti-trust issues with relevant authorities, inadequate information provision by bidders and other crimes. It summarizes how measures relating to litigation could help delay the hostile takeover process, but could also terminate it, even if the target company is only seeking a greater share premium. This process could also involve government intervention, and its effectiveness cannot be guaranteed. Even if this group of measures are the most frequently used tactics by target companies, this thesis does not recommend it over other options.

Chapter 7 analyses and compares the legislative systems of the US and UK and concludes that the UK’s system is better for contemporary China. However, there is

still the potential for China to legalise certain takeover defensive measures in the future as China's market is continually being reformed.

Chapter 8 concludes the thesis in proposing that China is justified in adopting the UK's shareholder-friendly regulatory system. This is partly based on consideration of promoting takeover activities, and the existence of China's SOEs, which may be reasons to prohibit certain defensive measures in China's market. As the reform of China's market continues, moderate defensive tactics like the white knight, parachute system and poison pill could work well. However, the decision-making power should remain in the hands of shareholders and the government should provide sufficient supervision over the market whilst following the principle of protecting shareholders' interests.

The importance of the thesis, and its contribution to existing knowledge, is the research for it has found that most other researchers are focused on the mandatory bid rule – adopted from the UK – in China, but that hardly any systematic research is being undertaken into defensive measures. Thus, this thesis fills a gap in the current literature on the takeover regulations area for China. It also discusses most of the major takeover defensive tactics, analysing in which markets certain defensive tactics work, and whether they would be appropriate for China. Newly-released regulations show the intention of Chinese legislators to turn to a more US style – which will make certain takeover defence measures possible in China, such as the poison pill; whether these are suitable for the Chinese market is debatable. In addition, it is found that

Chinese companies, especially high-tech companies, quite frequently use several defensive measures when they list on the US market, and the function of these tactics in securing control over the target company can be seen. Thus, research into how to regulate those defensive measures and what problems might arise with their use in China is important for regulators, and will make this thesis meaningful in China.

Declaration

I hereby declare that no portion of the work that appears in this study has been used in support of an application of another degree in qualification to this or any other university or institutions of learning.

Copyright

The copyright of this thesis rests with the author. No quotation from it should be published without the prior written consent and information derived from it should be acknowledged.

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Chapter 1: Introduction

1. M&A

Mergers and acquisitions (M&A) are processes that occur ‘when an individual or a group acquires the whole or substantial equity share capital or assets of a publicly listed company’.¹ In recent years, there has been much M&A activity around the world. The first wave of mergers occurred between 1897 and 1904,² and Asia is now a part of what is the fifth major merger wave.³ The pace of mergers and acquisitions picked up in the early 2000s after a short hiatus in 2001.⁴ It is now widely believed that M&A is the quickest way to expand an acquirer’s business,⁵ and it is also found that takeovers are more likely to take place because the market players’ needs to keep abreast of prevailing corporate trends⁶. M&A is a continually evolving field⁷ in the contemporary world of economic and legal research.

¹ Alan Peacock and Graham Bannock, *Corporate Takeovers and the Public Interest* (Aberdeen University Press 1991) 7.

² EconomyWatch, ‘History of Mergers and Acquisitions’ (2010)

² EconomyWatch, ‘History of Mergers and Acquisitions’ (2010)

<<http://www.economywatch.com/mergers-acquisitions/history.html>> accessed 07 May 2012.

³ Patrick A. Gaughan, *Mergers, Acquisitions, and Corporate Restructurings* (5th edn, John Wiley & Sons 2010) 3.

⁴ Ibid 3.

⁵ Patrick A. Gaughan, *Mergers, Acquisitions, and Corporate Restructurings* (4th edn edn, John Wiley & Sons, Inc. 2007) 14.

⁶ A.D. Chandler, *Scale and Scope: The Dynamics of Industrial Capitalism* (Harvard 1990) 17. Cited from Christian Witting, *Liability of Corporate Groups* (forthcoming), chapter 2.

⁷ Patrick A. Gaughan, *Mergers, Acquisitions, and Corporate Restructurings* (4th edn edn, John Wiley & Sons, Inc. 2007) 68.

Manne argues that potential bidders monitor the share price of public companies, looking for underperformance: “The lower the stock price, relative to what it could be with more efficient management, the more attractive the takeover becomes to those who believe that they can manage the company more efficiently.”⁸ Some takeovers promote economic efficiency, by permitting an increase in the scale of production and distribution, thereby lowering the cost of each unit of production.⁹ For example, it is argued that the improved corporate management and increased efficiency in the company brought the shareholders large premiums.¹⁰ And there are economists pointed out the improved efficiency caused by the takeovers also helped to increase the market value.¹¹ But problems can also arise from the existence of the threat of a takeover; it is argued for example that such a threat will distract managers from concentrating on long-term profit maximization.¹² Also, Shleifer and Summers argued that “hostile takeovers facilitate opportunistic behavior at the expense of stakeholders, and it enable shareholders to transfer wealth from stakeholders to themselves more than create wealth...So it is incorrect to gauge the efficiency gains

⁸ Henry G. Manne, ‘Mergers and the Market for Corporate Control’ (1965) 73 *Journal of Political Economy* 110, 113.

⁹ Jr. John C. Coffee, ‘Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance’ (1984) 84 *Columbia Law Review* 1145, 1149.

¹⁰ Jensen, M. C., ‘Takeovers: Folklore and Science’ (1984) 62 *Harvard Business Review* 109-21

¹¹ Andrei Shleifer and Lawrence H. Summers, ‘Breach of Trust in Hostile Takeovers’ in Alan J. Auerbach(ed), *Corporate Takeovers: Causes and Consequences* (University of Chicago Press 1988) 33

¹² Robert H Hayes and William J Abernathy, ‘Managing Our Way to Economic Decline’ (1980) Jul-Aug *Harv Bus Rev* 75,76.

from takeovers.”¹³ However, there is also empirical evidence that takeovers are value-maximizing events for target firm shareholders and enhance social efficiency.¹⁴ Each shareholder, acting according to their own economic calculations, seeks to maximize the returns on their investment in a target company either by agreeing to a bidder’s offer and selling their shares at a premium, or else they retain their shares when they consider the offer to undervalue the company. M&A activities therefore provide opportunities for both bidders and target company shareholders. Thus, even if there are criticisms regarding the disadvantages of M&A activities, it should not be forgotten that they do push the development of the global economy by facilitating efficiency. In this thesis, it believes the positive effect of takeover activities on the improvement of corporate management and efficiency and argues that the takeovers could help the development of the market.

In practise, most M&A activities start with a tender offer from the bidders. This offer aims to allow the bidder to buy shares in the target company ‘at an offered price within a certain period’.¹⁵ In the US, the tender offer itself is regulated by the Securities and Exchange Commission, while the courts regulate managers’ responses

¹³ Andrei Shleifer and Lawrence H. Summers, ‘Breach of Trust in Hostile Takeovers’ in Alan J. Auerbach(ed), *Corporate Takeovers: Causes and Consequences* (University of Chicago Press 1988) 34

¹⁴ Charlie Xiao-chuan Weng, ‘Lifting the Veil of Words: An Analysis of the Efficacy of Chinese Takeover Laws and the Road to the Harmonious Society’ (2011) 24 *Columbia Journal of Asian Law* 181, 182.

¹⁵ Joy Dey, ‘Efficiency of Takeover Defence Regulations: A Critical Analysis of the Takeover Defence Regimes in Delaware and the U.K.’ <<http://ssrn.com/abstract=1369542> > accessed 05 March 2012 7.

to a bid.¹⁶ Even though it has not been defined in statutes or regulations within the US, American courts have attempted to define tests to ascertain if certain activities amounted to a tender offer.¹⁷ In the UK (but not the US), there is also a mandatory bid rule, such that anybody who acquires over 30 per cent of the voting shares of a target company must make an offer to purchase the remaining shares of that company¹⁸. This is designed to ensure a fair exit opportunity for all shareholders upon a change of control in the target company.¹⁹

2. Hostile takeovers

Hostile takeovers first emerged in the 1950s in the UK, and since then have happened increasingly frequently over time, in companies with dispersed stock ownership,²⁰ in countries with developed markets. A hostile takeover is the one that proceeds without the support of target company management. Offers to purchase are made directly to

¹⁶ John Armour and Jr. David A. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 Georgetown Law Journal 1727, 1743.

¹⁷ Joy Dey, 'Efficiency of Takeover Defence Regulations: A Critical Analysis of the Takeover Defence Regimes in Delaware and the U.K.' <<http://ssrn.com/abstract=1369542>> accessed 05 March 2012 7.

¹⁸ John Armour and Jr. David A. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 Georgetown Law Journal 1727, 1736.

¹⁹ Joy Dey, 'Efficiency of Takeover Defence Regulations: A Critical Analysis of the Takeover Defence Regimes in Delaware and the U.K.' 11 <<http://ssrn.com/abstract=1369542>> accessed 05 March 2012.

²⁰ John Armour, Jack B. Jacobs and Curtis J. Milhaupt, 'The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework' (2011) 52 Harvard International Law Journal, 221, 221.

target shareholders.²¹ It is argued that, based on consideration of ‘law and economics’, a hostile takeover mostly happens while the target company is under poor management and the acquirer could serve the function of replacing the incumbent management with a new board.²² It is also acknowledged by some researchers that hostile takeovers became the major threat, other than the governance devices of corporate law, because they could provide opportunities for a target company to improve its performance if it is taken over by a bidder, and otherwise, provide a good reason for directors to keep on their toes, worrying about a hostile bidder preying on the company.²³ Evidence shows that takeovers, especially hostile takeovers, at least increase the target company’s shareholders’ wealth in the near future, and that the minority shareholders of the target company also benefit from successful takeovers.²⁴ It could be expected that replacement of an inefficient management system with a better one could increase the price of the corporation’s shares. However, there are still

²¹ *Edgar v. MITE Corp.* 457 US 624 (1982).

²² Juan Chen, *Regulating the Takeover of Chinese Listed Companies: Divergence from the West* (Springer 2014) 47.

²³ John Armour and Jr. David A. Skeel, ‘Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation’ (2007) 95 *Georgetown Law Journal* 1727, 1733.

²⁴ Marco Ventoruzzo, ‘The Thirteenth Directive and the Contrasts Between European and U.S. Takeover Regulation: Different (Regulatory) Means, Not So Different (Political and Economic) Ends?’ Bocconi Legal Studies Research Paper No 06-07 <<http://ssrn.com/abstract=819764>> accessed 20 Jan. 2013 9.

those who question the efficiency-enhancing characteristics of hostile takeovers, such as the SEC Advisory Committee.²⁵

High takeover premiums can have a distorting effect on decision-making by target company shareholders.²⁶ This is because the premium can sometimes be as much as a hundred per cent of the share price. Thus it is understandable that most of a target's shareholders may be swayed by the instant profit offered by the deal even though they believe that the target company may have better long-term prospects as an independent company. For example, Vodafone AirTouch paid £112bn to take over its rival Mannesmann in Germany in 2000,²⁷ which became the largest corporate merger up to that time. Although 90% of shareholders believed that Mannesmann had better long-term prospects as an independent company, they were nonetheless swayed by the instant profit offered by the deal.²⁸

In addition, a hostile takeover could cause inequality. Some claim that those who accept a bidder's offer should compensate the shareholders who surrendered their rights.²⁹ However, it is unreasonable to give any shareholders particular consideration

²⁵ Cited in Jr. John C. Coffee, 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance' (1984) 84 Columbia Law Review 1145 note 3 and note 13.

²⁶ Zhongwen Huang, Xiangdong Liu and Jianliang Li, *Waizi Zaihua Binggou Yanjiu (Research on Foreign Capital M&A in China)* (China Financial Publishing House 2010) 148.

²⁷ BBC, 'Vodafone Seals Mannesmann Deal' (BBC, 11 February 2000)
<<http://news.bbc.co.uk/1/hi/business/630293.stm>> accessed 10 March 2012.

²⁸ BBC, 'Mannesmann: A Culture Shock' (BBC, 4 February 2000)
<<http://news.bbc.co.uk/1/hi/business/631413.stm>> accessed 15 March 2012.

²⁹ Tunde I. Ogowewo, 'The Inequality of Equality in Takeovers' 23 JIBLR 178, 178.

when selling to a buyer seeking control of a company. This should not be seen as an unequal treatment of shareholders, but as the difficulties incurred by collective actions: an offeror cannot be required to ‘make whole’ offeree shareholders in respect of the personal relationship they may have with the offeree.³⁰ It is also acknowledged that not all shareholders are likely to favour the offer from a bidder; thus it is claimed that different classes of shareholders may be treated unequally in the process of the takeover. As a matter of fact, according to the Takeover Code, the shareholders in the target company have the rights to have comparable offers if the company has different classes of shareholders³¹ and same information should be provided as soon as possible at the same time.³² Nonetheless, in the UK law directors are under a duty to treat shareholders fairly – not necessarily equally.³³ More importantly, the “squeeze out” rule and the “sell out” rule could provide the minority shareholders sufficient protection once the offeror gain acceptances of 90 per cent in value of the shares.³⁴ Thus it could be seen that all the shareholders’ rights could be protected under a reasonable fair basis. Also, a general concept within UK law is that controlling shares are worth more than non-controlling shares,³⁵ so it might be argued that the pursuit of equal treatment should not influence the content of takeover regulation too much.³⁶

³⁰ Ibid 182.

³¹ The Takeover Code 2013 Rule 14.1.

³² The Takeover Code 2013 Rule 20.1 and Rule 23.

³³ *Mutual Life Insurance Co of New York v The Rank Organisation Ltd* [1985] BCLC 11.

³⁴ “Squeeze-out” and “Sell-out”, Ch.3 Pt.28 Companies Act 2006

³⁵ *Shrot v Treasury Commissioners* [1948] AC 534 (HL).

³⁶ Paul L Davies, ‘The Notion of Equality in European Takeover Regulation’ in Jennifer Payne (ed), *Takeovers in English and German Law* (Hart Publishing 2002) 5.

No matter who assess the impact of hostile takeover, the advent of it has been recognised as a stimulus for the development of new takeover regulatory regimes, and created a new challenge for corporate control.³⁷

3. Takeover defences (2 modes)

Hostile takeovers have taken place for decades, and given that they pose threats not only to the shareholders of the target company, but also to its management, the need to regulate market control in the takeover field is critical. However, different jurisdictions have different ways of controlling tender offers or hostile bids.³⁸ There are two predominant takeover defence environments in the world: one is the US's and the other is the UK's. In the US, takeover activities are regulated by a variety of state and federal laws, and the Delaware law is the primary piece of legislation that regulates takeover defences. 'In the comparison of the regulation of takeover activities in the US and UK, particularly those related to the freedom of adopting defensive tactics against takeover bids', Armour and Skeel argued, 'in the UK, defensive tactics by target managers are prohibited, whereas in the United States, the Delaware law gives managers a good deal of room to manoeuvre.'³⁹ In the US, the

³⁷ John Armour, Jack B. Jacobs and Curtis J. Milhaupt, 'The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework' (2011) 52 Harvard International Law Journal 221, 222.

³⁸ Joy Dey, 'Efficiency of Takeover Defence Regulations: A Critical Analysis of the Takeover Defence Regimes in Delaware and the U.K.' 3 <<http://ssrn.com/abstract=1369542> > accessed 05 March 2012.

³⁹ John Armour and David A. Skeel, 'The Divergence of U.S. & U.K. Takeover Regulation' (2007) 30 Regulation 50, 50.

mode of regulation is ‘the domain of courts and regulators’,⁴⁰ and is fundamentally manager-friendly as it gives the power to refuse a bid to the managers. Conversely, the UK’s takeover defence system is shareholder-friendly, and seems to facilitate the frequency of takeovers by giving defence powers to shareholders in seeking to resolve takeover issues. Even if the mandatory bid rule could deter the takeover to some extent, and the market for corporate control could be really competitive to make the target company more attractive to potential raiders so the takeover process could be deterred as well. But it could be said that the prohibition of the takeover defensive measures for the directors did lower the difficulty level of takeover offer compared to the regulation system in the US since there could be more pre-bid defensive measures included in the target company’s article.

When discussing the delegation of the powers to defend against hostile takeovers in these two systems, agency cost is a key issue to consider. Like most real-world agents, managers are not always entirely faithful to their principals. Their incentives are likely to diverge from those of the shareholders and, when this happens, managers may be inclined to pursue their own interests at the shareholders’ expense.⁴¹ This

⁴⁰ John Armour and Jr. David A. Skeel, ‘Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation’ (2007) 95 Georgetown Law Journal 1727, 1743.

⁴¹ Julie Wulf, ‘Do CEOs in Mergers Trade Power for Premium? Evidence from "Mergers of Equals"' (2004) 20 J L Econ & Org 60, 96; Jay C. Hartzell, ‘What's in It for Me? CEOs Whose Firms Are Acquired’ (2004) 17 Rev Fin Stud 37, 59 . This report showed that CEOs in target companies gained more personal benefits than shareholders and obtained greater post-merger control rights while target shareholders obtained a smaller proportion of joint gains.

phenomenon is referred to as “agency cost(s)”.⁴² If a takeover bid is successful, current managers may be replaced by others, who will presumably be better, so existing managers must compete against potential acquirers for the right to continue to manage corporate resources. Consequently, both shareholders and directors have distinct attitudes towards the market regarding corporate control. Thus, it is reasonable for shareholders to question directors’ motives when they are employing defensive measures against a hostile takeover bid. Undeniably, takeovers carry the risk to target company directors that they will lose their jobs; hence, directors are likely to prefer a regulatory system in favour of them. It is understandable that almost all directors would like “their behaviours to be as unconstrained as possible”;⁴³ presumably, if managers were opposed to a takeover, they might be expected to lower the likelihood of the offer succeeding by using takeover defensive tactics which shareholders may not prefer. Thus, it is argued by scholars that in the US, takeover defences are commonly thought to be motivated by management’s interest in entrenching itself.⁴⁴

According to Armour and Skeel’s research, the UK system has some clear advantages. The first relates to the speed of conducting a takeover: the bidder should follow up on its intention to make a formal offer by doing so within 28 days. In the US, there is no

⁴² Donald Rutherford, *Dictionary of Economics* (1992) 10, This dictionary defines the term “agency cost” as a “cost arising from a contractual relationship between a principal and an agent”.

⁴³ Joordan M. Barry & John William Hatfield, ‘Pills and Partisans: Understanding Takeover Defences’ (2012) 160 *University of Pennsylvania Law Review* 633, 640.

⁴⁴ Robert Daines & Michael Klausner, ‘Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs’ (2001) 17 *JLEcon & Org* 83, 83.

clear timetable for that.⁴⁵ Second is the potential for high litigation costs in the US. Data shows that one third of hostile takeovers in the US are litigated,⁴⁶ and this may involve high costs in hiring lawyers and may also be time-consuming. Hostile takeovers in the UK do not experience this. Thus, the UK's process appears to be quicker and cheaper than the US, and is also more proactive in response to market developments.

In both takeover regulatory systems, takeover defensive tactics can be adopted at a pre-bid stage, or a post-bid stage. However, 'no defensive measure can be said to be foolproof, and some may be disadvantageous as well, depending on the particular situation of a corporation. However, every tactic affords some negotiation leverage and time to formulate strategies for safeguard.'⁴⁷ Pre-bid strategies include poison pills, shark repellents, dual-class stock, sale of assets, friendly hands, while post-bid strategies include greenmail, the Pacman defence, white knights and white squires, employee stock ownership plans, leveraged capitalization, and share buy-back plans.⁴⁸

⁴⁵ John Armour and Jr. David A. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 Georgetown Law Journal 1727, 1745-1746.

⁴⁶ Ibid.

⁴⁷ Joy Dey, 'Efficiency of Takeover Defence Regulations: A Critical Analysis of the Takeover Defence Regimes in Delaware and the U.K.' <<http://ssrn.com/abstract=1369542> > accessed 05 March 2012 5.

⁴⁸ Ibid 5-6.

Thus it is easy to know that each kind of takeover regulatory system has its own pros and cons and it is hardly to say either of them will fit in all countries. Succinctly, some scholars hold the opinion that the UK's takeover system has clear advantages.⁴⁹ It is also argued that a hostile takeover is easier in the US because of a 'network effect'⁵⁰ and that it is easier to 'anticipate the types of hurdles and judicial treatment that takeovers are likely to experience' in the US, rather than UK system.⁵¹ But the UK rules are clearer ex ante than those of the US since the UK's rules are set in the Code and the US's rules are depending on the judicial fact-finding rules in Delaware.

This thesis, will consider the circumstances in the UK and US to establish why regulators chose certain systems for each market and how the takeover regulatory systems of these western markets might or might not fit in China's unique market and legal framework, and which system provides better lessons that China may learn from.

4. China's circumstances

In China, the wholly private companies could be traded freely in the market as they are in the western markets but the SOEs are not. So in the following part it will

⁴⁹ John Armour and Jr. David A. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 Georgetown Law Journal 1727. In this paper, the authors illustrated the advantage of the UK's regulatory system compared with the US's, and conclude that the UK's system is more efficient than the US'.

⁵⁰ Sharon Hannes, 'The Hidden Virtue of Antitakeover Defences' (2002) Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper Series. Paper 354 available at <http://lsr.nellco.org/harvard_olin/354> accessed 12 July 2015 page 58.

⁵¹ Ibid.

discuss the key special market player in China – the SOEs for a better discussion of which regulation system will be more suitable for China. To provide a better understanding of China's market before discussing China's regulation of takeover activities, the existence of state-owned enterprises, which represent a large percentage of capital in China's market, should first be considered.

1) Discussion of the existence and functions of China's SOEs: how are these SOEs affecting China's development?

In general, there are three kinds of SOEs in China, with different percentage of shares owned by the state. These are: 1) wholly state-owned enterprises; 2) state-controlled enterprises, and 3) state holding enterprises.⁵² Wholly state-owned enterprises are those where 100 per cent of the capital is owned by the state, while state-controlled enterprises are ones where the state owns a controlling percentage⁵³ of shares. In state holding enterprises, the state invests some capital into those companies but does not actually control them, so these companies are similar to other companies in the

⁵² National Bureau of Statistics of the PRC [2003] 44 Letter about the Opinions to Identify a State Owned Enterprise [Guanyu Dui Guoyou Gongsi Qiye Rendeng Yijian de Han] (2009) available at http://www.stats.gov.cn/statsinfo/auto2072/201311/t20131104_454901.html, accessed 08 May 2014.

⁵³ Generally, the state will own more than 50 per cent of shares and have absolute control of a company. In some cases, the state may have less than 50 per cent of shares of the company, however, the percentage will still more than other shareholders such that the state can still control the company as the biggest shareholder; in those circumstances, these companies are also state-controlled enterprises. See: *ibid*.

market, with the important difference of the existence of a special non-shareholder – the state.⁵⁴

Wholly state-owned enterprises and state-controlled enterprises include 113 central enterprises and some locally administered, state-owned enterprises, which are governed by 36 provinces (autonomous regions; cities).⁵⁵ The 113 central enterprises are governed by the State-Owned Assets Supervision and Administration Commission (SASAC) and companies such as the China Railway Corporation and China Post Group are governed by Ministry of Finance of China.⁵⁶

Those 113 central enterprises are mainly enterprises within the nuclear industry, oil industry, weapons industry, etc.⁵⁷ – key industries for the development of the country. Thus those industries are not open to public investors because of their special importance to the development of the country. In addition, some enterprises⁵⁸ have a monopoly within their industries, although most industries are gradually changing towards a more open and free market because of the driving force of progress brought

⁵⁴ Ibid.

⁵⁵ The Enterprise Department of Ministry of Finance of the PRC, ‘The Economic Operation of the SOEs in China During January to March in 2014 [2014 Nian 1-3 Yue Quanguo Guoyou ji Guoyou Konggu Qiye Jingji Yunxing Qingkuang]’ (18 April 2014) <http://qys.mof.gov.cn/zhengwuxinxi/qiyeyunxingdongtai/201404/t20140418_1069082.html> accessed 29 April 2014.

⁵⁶ Ibid.

⁵⁷ State-owned Assets Supervision and Administration Commission of the State Council, ‘List of Central Enterprises’ <<http://www.sasac.gov.cn/n1180/n1226/n2425/>> accessed 10 May 2014.

⁵⁸ There are seven natural monopoly industries in China. Those are: the military, the grid and power industry, the oil and petrochemical industry, the telecommunication industry, the coal industry, the civil aviation industry and the shipping industry. See Jiansan Shi and Shiyu Qian, *Comparative Study on Antimonopoly Review of M&A* (Lawpress China 2010) 35.

by competition.⁵⁹ It can also be predicted that China's monopoly enterprises will join in the future competitive environment in the same way that those in developed countries did when there is a more sound market to support the protection of state services and to ensure the stability of society. That said, judging from the current situation, it is not yet time for the government to release power to the market to operate freely because of the lack of experience and sufficient legal protection. There remains the need for a legal system that is constructed in accordance with Chinese characteristics, and does not just replicate an advanced foreign legal system.

The SOEs have a strong set-up: the state protects them from competition within the market. That does not necessarily mean that SOEs have no competitors, however. In the case of Sinopec and ENN Energy vs. China Gas, the announcement of a hostile takeover bid helped China Gas's share price rise over subsequent months, probably because of the increase in the percentage of China Gas's shares owned by its white knights. The share price reached 4.26 HKD per share after hostile raiders officially gave up on their takeover intention in 2012, which was far higher than the hostile offer of 3.5 HKD per share. Thus, it could be presumed that the announcement of the hostile takeover brought China Gas to public investors' attention as a company with a strong potential for listing; the failure of the hostile takeover also demonstrated the target's power to defend against such a move, indicating that it may have the ability to solve such crises in the future. Both Sinopec and China Gas were wholly state owned

⁵⁹ Ibid 36.

SOEs, and this hostile takeover attempt shows that even SOEs have competitors – both SOEs in the same industry and some non-SOEs. Also, the State Owned nature of China Gas should not be ignored, as whilst the state is a powerful supporter for a company, this does not mean that the state is in full control over all listed companies that exist in the market, which includes non-SOEs. Thus, whilst the market in China is distinctive, it cannot be said that western countries’ regulating strategies would not work based on assumptions of the market not being ‘free’.

2) Continuing reforms of China’s SOEs in the new era

The existence of SOEs has a large impact on China’s market and indirectly affects the creation of relevant regulations. Whether and how these SOEs may change in the future should be considered crucial when regulating market activities.

In China, reforms to SOEs have not stopped since President Xi and his team sought to increase their effectiveness. For decades, China had put SOEs in leading positions in China’s market and used this as a principle to guide the development of China’s market in 1999 in Several Major Resolutions by the Central Committee of the CPC on the Reform and Development of State Owned Enterprises.⁶⁰ Even though China’s SOEs have frequently been criticized by researchers, their leading status seems to be

⁶⁰ Zhonggong Zhongyang Guanyu Guoyou Qiye Gaige he Fazhan Ruogan Zhongda Wenti de Jueding [Several Major Resolutions by the Central Committee of the CPC on the Reform and Development of State Owned Enterprises] The Fourth Plenary Session of the 15th Central Committee of the CPC, 22 September 1999.

unshakable.⁶¹ That is to say, any suggestions that hinge on the abolition of China's SOEs or totally privatising SOEs are not likely to be applicable to contemporary China.

In the regulation of activities in China's market, certain political and administrative factors should be considered in order to make the regulation fit the market. Although SOEs are owned by the state and have a political background, they can still be good market players if they have good corporate governance systems. Indeed, China has endeavoured to improve SOEs' performance in the market during these years to keep up with the pace of the market's development. Every administrative team in China was trying to secure the leading position of state owned companies: according to former president Zemin Jiang's report at 16th Party Congress on Nov 8, 2002, during the "reform toward the socialist market economy" in China should "stick to and improve ... the state property management system."⁶² In addition, President Jintao Hu's report at the 17th Party Congress in 2007 emphasized the importance of the reform of the shareholding structures of SOEs, as well as of their corporate governance systems.⁶³ Moreover, at the 18th Party Congress in November 2014,

⁶¹ Juan Chen, *Regulating the Takeover of Chinese Listed Companies: Divergence from the West* (Springer 2014) 11.

⁶² Zemin Jiang, 'Build a Well-off Society in an All-Round Way and Create a New Situation in Building Socialism with Chinese Characteristics' (The Sixteenth National Congress of the Central Committee of the Communist Party of China (CPC)) available at <http://cpc.people.com.cn/GB/64162/64168/64569/65444/4429120.html> accessed 1 November 2014.

⁶³ Jintao Hu, 'The Report of Jintao Hu at 18th Party Congress' (The Seventeenth National Congress of the Central Committee of the Communist Party of China (CPC)) available at <http://cpc.people.com.cn/GB/64093/67507/6429847.html> accessed 1 November 2014.

present President Jinping Xi reaffirmed the importance of reforms of SOEs and proposed deeper reforms and changes to achieve a more effective and fairer market in China.⁶⁴ Consequently, it is clear that the reform of China's SOEs has been a priority over recent years and there are no signs to indicate the government will remove the SOE concept from the market.

The results of these reforms can be expected to emerge over time. Although China's market is not as free as western markets and there are certain defects in it, the efforts of China's government into improving the market have had positive effects. Additionally, the new administrative leadership has expressed their plan to continue to work towards an advanced market by pushing the idea of "mixed ownership" and increase SOEs' vitality, control, and influence;⁶⁵ thus it could be seen that after many years of trying, China has found its own way to develop its economy, learned from – but not totally the same as –western countries' systems. The creation of takeover regulation may follow a similar pattern. Though the existence of SOEs makes China's market more distinct, and China should not copy everything from western markets, a regulatory system, which bears similarities to a western one, could yet fit China's market.

⁶⁴ Jinping Xi, 'Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform' (The Third Plenary Session of the 18th CPC Central Committee) available at <http://cpc.people.com.cn/n/2013/1115/c64094-23559163.html> accessed 1 November 2014.

⁶⁵ Ibid.

To some extent, SOEs' defects were quite possibly caused by their own administrative systems: something that may be changed through reform. Scholars have criticised the transfer of control of SOEs by the state for having political incentives, because most privatized SOEs were badly managed and the state wanted to take the advantage of privatization to help the performance of these companies as well as reduce the financial burden on the state.⁶⁶ However, Jin's research has revealed the differences between SOEs and other companies and confirmed the importance of SOEs in the market.⁶⁷ In addition, there is other research that shows there are ways in which China may improve the effectiveness of SOEs' production.⁶⁸ However, scholars have pointed out a distinctive feature of the SOEs that makes them different from other companies: that is, the corporate governance in a SOE is easily affected by political factors.⁶⁹ In addition, the agency problem could be more serious in SOEs than in other companies, as whilst there are executive directors in SOEs in charge of making decisions, SASAC can issue orders to those directors since these directors occupy an administrative position that sits under the SASAC. Thus, the decision-making power of directors is indirectly controlled by the SASAC,

⁶⁶ Jijun Yang, Dong Lu and Dan Yang, 'State-owned Enterprisesp Government Control Right Transfer' (2010) 2 Economic Research 69, 69.

⁶⁷ Bei Jin, 'Repositioning State-Owned Enterprises Reform' (2010) 13 Xinhua Wenzhai 45, 49.

⁶⁸ Yanbing Wu, 'The Dual Efficiency Losses in Chinese State-Owned Enterprises' (2012) 3 Economic Research 15,26.

⁶⁹ The integration of government administration with enterprise is a long-standing issue in China and is still unresolved now. Scholars point out that the reform of SOEs was only launched recently. Further details could be found in Hongliang Zheng, 'Corporate Governance Theory and China's SOEs Reform' (1998) 10 Economic Research 20 and Yanbing Wu, 'The Dual Efficiency Losses in Chinese State-Owned Enterprises' (2012) 3 Economic Research 15, 26.

representing the state. Consequently, there should be concerns about delegating power to directors which may in actuality mean the state has too much power over the market. That said, there may be resolution to the agency problem in China. According to President Xi's report at the third plenary session of the 18th CPC Central Committee, China will endeavour to promote a "mixed-ownership" structure in the market and try to "improve the State-owned assets-management system and strengthen State-asset supervision by focusing on capital management."⁷⁰ As a result, SOEs would become part of the competition in the market with less state interference. Also, if those aims are achieved over the coming years, SOEs may develop a modern corporate governance system and perform more effectively. If directors were given more control over the company, their decisions may reflect the orders of the state less and be more in the best interests of the listed company and its shareholders.

3) Hostile takeovers in China

For China, hostile takeovers are a rare phenomenon, because of a lack of dispersed stock ownership and the fact that the country is still at an early stage of economic development. As the Chinese economy continues to grow dramatically, it has begun to increasingly look outside its borders for acquisition candidates. The 2005 acquisition of IBM's PC business by Lenovo is one example. However, the acquisition of Chinese companies by non-Chinese firms is difficult and risky, as

⁷⁰ Jinping Xi, 'Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform' (The Third Plenary Session of the 18th CPC Central Committee) Pt.2.

China is still in the early stages of becoming less centralized and more of a free market economy.⁷¹ Figures show that China's economy has realized double-digit growth for a number of years, but there are still many regulatory restrictions imposed on M&A in China that inhibit the volume of deals rising to levels that would naturally occur in a less controlled environment. The Chinese regulatory authorities have taken measures to ensure that Chinese control of certain industries and companies is maintained, even as the economy moves to a more free market status.⁷²

Prior to the Administrative Measures for Strategic Investment by Foreign Investors in Listed Companies (potentially reversing a long-term policy limiting the ability of foreign investors to acquire controlling positions in Chinese companies), foreign investors were limited in their ability to acquire tradable Class-A shares and were often restricted to non-tradable Class-B shares, which are less appealing. The new rules opened up the Chinese market for foreign investors to purchase tradable shares, however. Nonetheless, this does not mean that the market is totally open and that foreign investors have an unrestricted ability to acquire control over Chinese corporations. In fact, after opening the door for foreign investors to purchase tradable Class-A shares, China adopted additional rules that required foreign buyers of Chinese assets to obtain Ministry of Commerce clearance before completing deals

⁷¹ Patrick A. Gaughan, *Mergers, Acquisitions, and Corporate Restructurings* (4th edn edn, John Wiley & Sons, Inc. 2007) 6.

⁷² Patrick A. Gaughan, *Mergers, Acquisitions, and Corporate Restructurings* (5th edn, John Wiley & Sons 2010) 4-5.

involving key industries and well-known Chinese brands.⁷³ The restriction of foreign companies purchasing shares in China's market applies to all types of companies. To be specific, according to Regulation on Domestic Securities Investment by Qualified Foreign Institutional Investor, foreign institutional investors could only purchase certain amount of A-shares in China's stock market if it got the qualification of Qualified Foreign Institutional Investor (QFII).⁷⁴ Any foreign institutional investor should meet the requirements of being a QFII and apply to the CSRC and State Administration of Foreign Exchange (SAFE) to decide whether it can get the qualification and the maximum allowance it can invest in China's stock market.⁷⁵

It is true China does not have a totally open market at present, but no market is entirely open to all foreign investors. Indeed, 'if US readers find such restrictions inconsistent with their desire for open and free markets, they need to remember the relatively recent opposition to Chinese Petroleum company CNOOC's bid for Unocal on 'national security' grounds and realize that even countries which hold themselves out to be 'free marketers' may deviate from such a stance for political reasons.'⁷⁶

⁷³ Ibid 93.

⁷⁴ Regulation on Domestic Securities Investment by Qualified Foreign Institutional Investor 2006, a.2 and a.5.

⁷⁵ Ibid a.6, a.7 and a.8.

⁷⁶ Patrick A. Gaughan, *Mergers, Acquisitions, and Corporate Restructurings* (5th edn, John Wiley & Sons 2010) 93.

The ownership structure in China has changed in recent years and China's takeover regime has taken her initial shape. It seems likely that evolution will continue for both in the future.⁷⁷

In the wake of the development of China's economy and the adoption of some advanced regulations similar to those of major industrial countries like the US and the UK, several issues have been vigorously debated, and the takeover regulatory system is one of them. According to the *China M&A Law Report*, research on M&A in China is conducted from diverse angles. Before 2009, much research adopted an anti-trust perspective to analyse the problems with takeover issues, but the field of research has now expanded to encompass the national security review, takeover defence tactics, and tender offer regulations. Most saliently, 10 per cent of published papers relating to M&A issues focus on takeover defence regulations,⁷⁸ which indicates that takeover defence issues have come to receive more and more attention from researchers over time.

In recent years, whilst hostile takeovers have occurred in large, highly developed industrial countries with sophisticated markets, they seem to have been less experienced in emerging markets such as China, Brazil and India.⁷⁹ Now, data show

⁷⁷ John Armour, Jack B. Jacobs and Curtis J. Milhaupt, 'The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework' (2011) 52 *Harvard International Law Journal* 221, 223.

⁷⁸ *China M&A Law Report* (Jiansan Shi ed, Law Press China 2010) 410.

⁷⁹ John Armour, Jack B. Jacobs and Curtis J. Milhaupt, 'The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework' (2011) 52 *Harvard International Law Journal*, 221, 273.

that M&A activities in China have increased considerably, but that the rate was ‘still relatively low compared to that of the US or the UK’,⁸⁰ and few bidders attempted takeovers of targets in an unsolicited way. China, which in 2011 ranked 2nd in the world for GDP,⁸¹ experienced few hostile takeover cases that were completed successfully. This is because China is a distinct environment where ‘there is little immediate prospect of a market for corporate control developing’.⁸² The shareholding structure is very distinct in China because most shares are state-owned or state-owned legal person shares and both are not tradable in the market. Thus, ‘the transformation of state-owned enterprises into publicly traded companies in the process of China’s market opening has only been partial – indeed, the term used is *corporatization*, not *privatization*’.⁸³

Most corporations in mature capitalized markets such as the UK and US will defend against hostile takeovers through the use of various tactics while companies in China seldom do so. Moreover, a large number of M&A activities in China are primarily undertaken in the secondary market, and potential hostile bidders can easily succeed in their activities by signing an agreement (transferring state-owned shares) with the majority shareholder (could be state or private) in control of the company. Thus,

⁸⁰ Ibid 273.

⁸¹ IMF, *World Economic Outlook Database* (International Monetary Fund 2012).

⁸² John Armour, Jack B. Jacobs and Curtis J. Milhaupt, ‘The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework’ (2011) 52 *Harvard International Law Journal*, 221, 274.

⁸³ Curtis J. Milhaupt and Katharina Pistor, *Law and Capitalism: What Corporate Crises Reveal About Legal Systems and Economic Development Around the World* (The University of Chicago Press 2008) 130.

potential hostile bidders can simply negotiate with the majority shareholder(s) to control the target company, rather than needing to use more complicated means and make a tender or hostile offer.⁸⁴ Therefore, there are few anti-takeover measures used in China's market.

Apart from the issue of the market environment, there is a gap in takeover defence legislation between China and advanced industrial markets. In China, there is no clear definition of a takeover defence, or of the delegation of powers for choosing to adopt a takeover defence in either Chinese *Company Law* or the *Securities Law*. However, according to related articles in *Company Law*,

The shareholders of a company shall be entitled to enjoy the capital proceeds, participate in making important decisions, choose managers and enjoy other rights.⁸⁵

The success of hostile takeover defence tactics may keep control in the hands of the current board and shareholders of the target company or raise the price of shares in order to get as high a premium as possible for the target company's shareholders. By contrast, the success of a hostile takeover may also change the management structure, which means the target company's shareholders may not be able to choose future managers of the company. Therefore, shareholders should have the power to decide

⁸⁴ Zhongwen Huang, Xiangdong Liu and Jianliang Li, *Waizi Zaihua Binggou Yanjiu, Research on Foreign Capital M&A in China* (China Financial Publishing House 2010) 148.

⁸⁵ Company Law of the People's Republic of China (2005 Revision) a. 4.

whether a defence against a hostile takeover is consistent with legislative intent.⁸⁶

According to *Measures for the Administration of the Takeover of Listed Companies (2008 Revision)*,

The decisions made and measures taken by the directors, supervisors and senior management of the target company with respect to the takeover activities may not prejudice the lawful rights and interests of the company or its shareholders.⁸⁷

Thus, it could be seen that the decision-making power is delegated to shareholders instead of directors because directors will need the approval of shareholders regarding the takeover activities' major issues. However, this is only an administrative regulation, which is not as powerful as a law. For this reason, many scholars have argued that the delegation of the decision-making power over takeover defence tactics to shareholders should be enshrined in law, not just by an administrative regulation.⁸⁸

It is predicted that hostile takeovers will occur more frequently in China, in the future.⁸⁹ According to PwC's research, the percentage of takeover activities in

⁸⁶ Qingmei Xu and Baoqian Li, 'Comment on the Legal Regulation of the Listed Corporation's Anti-Takeover in China' (2009) 25 Journal of University of Science and Technology Beijing (Social Sciences Edition) 55, 56.

⁸⁷ Measures for the Administration of the Takeover of Listed Companies (2008 Revision) a.33.

⁸⁸ Qingmei Xu and Baoqian Li, 'Comment on the Legal Regulation of the Listed Corporation's Anti-Takeover in China' (2009) 25 Journal of University of Science and Technology Beijing (Social Sciences Edition) 55, 56.

⁸⁹ Jianwen Wang, 'Anti-takeover Articles in the Articles of Incorporation' (2007) 2 Law Review 135, 135.

China's market grew 37 per cent compared with 2014, and it is predicted to grow at double-digit rates in the future.⁹⁰ It is known that many Chinese corporations reconstruct themselves by buying a shell, and M&A activities could provide a good platform for a back door listing, so that a hostile takeover may also be a good choice for bidders to buy an ideal shell. If the frequency of hostile takeovers increases, the use of anti-takeover measures may also be expected to increase accordingly.⁹¹

Most anti-takeover methods could theoretically be adopted, but some may not be suitable for China in practice. Thus, these measures should be discussed, in turn, to establish which specific takeover defence tactic might functionally be adopted.

However, not all research findings support the idea of focusing on the development of takeover defence tactics. It has been argued that the advent of takeover bids could promote the booming of the market, and that hostile takeovers, which can be seen as a major part of M&A activities, are regarded as an advanced mechanism which can both raise shareholder value and 'enhance the efficiency of the corporate system as a whole'.⁹² Thus takeover defence tactics could be an obstacle for an emerging market like China, as it is just at the beginning of its developmental path.

⁹⁰ PwC, "Review of China's M&A Market in 2015 and the Outlook of 2016[2015 Nian Zhongguo Qiye Binggou Shichang Huigu yu 2016]" (26 Jan 2016).

⁹¹ Ibid.

⁹² Simon Deakin and Giles Slinger, 'Hostile Takeovers, Corporate Law, and the Theory of the Firm' (1997) 24 *Journal of Law and Society* 124, 124.

The first takeover defence case arose in 1993, when Baoan Co. made an unsolicited offer to take over Yanzhong Co., and the target company complained to the CSRC about illegal activities that featured in the process, but the takeover still succeeded even if anti-takeover defence tactic was used.⁹³ Following that case, more than 20 anti-takeover cases arose in China between 1993 and 2009.⁹⁴ It was then claimed by an official report that China did not provide a good environment for M&A activities so that the top priority should be to facilitate the development of the M&A market, instead of setting obstacles to it, by improving the legislation of hostile takeover regulations.⁹⁵

That said, China's market has many other defects that pose a problem to the existence of hostile takeovers, such that takeover defence tactics may not be the most urgent issue for China to solve now.

Firstly, China's market does not feature the highly dispersed shareholding structures found in advanced industrial countries that allow bidders to achieve control through buying shares in the market. Instead, the 'organs of the central and provincial governments, or related affiliates, still control a majority of the shares of most companies listed on the Shanghai and Shenzhen stock exchanges'.⁹⁶ According to the

⁹³ Shanghai Stock Exchange Research Centre, *China Corporate Governance Report (2009)---The Market for Corporate Control and Corporate Governance* (Shanghai Stock Exchange, 2009) 120.

⁹⁴ Ibid 111.

⁹⁵ Ibid 127.

⁹⁶ Franklin Allen, Jun Qian and Meijun Qian, 'Law, Finance, and Economic Growth in China' (2005) 77 *J Fin Econ* 57, 85-86.

most recent data in China's stock market, it shows that there are 978 SOEs out of 2839 listed companies, and those SOEs take 48 per cent of the total capital of China's market.⁹⁷ Moreover, 'until recently, shares were not even legally tradable except to other state-affiliated investors.'⁹⁸

Secondly, the price of state-owned shares, legal shares and shares owned by individuals vary greatly, and most of the former shares' prices are cheaper than the latter's.⁹⁹ It is therefore understandable that bidders would prefer to control a target company by buying these cost-efficient shares instead of seeking control via a more complicated and less economical way.

Thirdly, Chinese Company Law sets some obstacles to transfer these state-owned or state-affiliated shares. The law regulates that major investment in a Chinese listed company must be approved by many government agencies, such as the Ministry of Commerce and the China Securities Regulatory Commission,¹⁰⁰ which highly limits the freedom of transactions in the market. Moreover, this regulation also gives market control to the state, and not to shareholders.

⁹⁷ Jianru Chen, 'The Gain and Loss of China's SOEs, Some Data You Should Know [Guoqi Shangshi Gongsu Yingkui Jihe Zhaxie Shuju Ni Buke Buzhi]' (*Securities Times*, 18 March 2016)

⁹⁸ Hui Huang, 'The New Takeover Regulation in China: Evolution and Enhancement' (2008) 42 *Int'l Law* 145, 153-158.

⁹⁹ Shanghai Stock Exchange Research Centre, *China Corporate Governance Report (2009)---The Market for Corporate Control and Corporate Governance* (Shanghai Stock Exchange, 2009) 111.

¹⁰⁰ Measures for the Administration of the Takeover of Listed Companies (2008 Revision) a.4 and John Armour, Jack B. Jacobs and Curtis J. Milhaupt, 'The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework' (2011) 52 *Harvard International Law Journal* 221, 275.

Fourthly, bidders may not have enough financing because of the inefficiency of China's market. As discussed, a hostile takeover may require bidders to pay a premium to target companies, so that the lack of funding (or funding efficiency) may cause takeovers to fail. Due to the special circumstances in China, many companies buy a 'shell' to be listed on the stock market so that the bidder company cannot raise finance via issuing shares to the public, which increases financing difficulty for the bidders.¹⁰¹ In addition, the issuing of enterprise bonds is restricted¹⁰² in China and the liquidity of such bonds is limited, so the risk of financing for bidders is extremely high.

In addition, the inexperience of market participants and the overestimation of the price of shares in China's market make hostile takeovers much more risky than in a mature market. Successful M&A activity depends on agents including investment banks, appraisal agencies, law firms and accounting firms.¹⁰³ Most do not offer services focusing on Anti-takeover areas, even though some large law and accounting firms offer professional services related to takeovers. On the other hand, most hostile bidders seek to takeover their target companies because of the potential for profit after

¹⁰¹ Shanghai Stock Exchange Research Centre, China Corporate Governance Report (2009)---The Market for Corporate Control and Corporate Governance (Shanghai Stock Exchange, 2009) 112.

¹⁰² According to Qiye Zhaiquan Guanli Tiaoli (Regulations on Administration of Enterprise Bonds) the enterprise bonds could not be issued to invest in the high risk investment, and the interests of the bonds have a strict requirement.

¹⁰³ Shanghai Stock Exchange Research Centre, China Corporate Governance Report (2009)---The Market for Corporate Control and Corporate Governance (Shanghai Stock Exchange, 2009) 112.

the merger, but if, as is suggested, the share prices for Chinese listed companies are frequently overestimated,¹⁰⁴ bidders may not realise desired profits in the end.

Given that the market in China seems not to provide an efficient market for mergers and acquisitions, an efficient legal protection system could be a good solution. The fact is, however, that China does not have a clear takeover regulatory system; it only mentions takeover rules in its Securities Law, Company Law and some related administrative regulations.¹⁰⁵ It is argued by scholars that the relationship between the bidder(s) and the target company could 'be supplied by means of a development of the principles of general corporate law, without the separation of a distinct body of takeover rules'.¹⁰⁶ To some extent, this is the approach adopted in the United States by state and Federal Law.¹⁰⁷ China first introduced M&A legislation in 1989¹⁰⁸ and the continuous updating of this legislation has provided a good basis for future development.¹⁰⁹

However, it is also argued that China has a highly developed takeover regime, at least as a formal matter. China's approach is a blend of the UK and US Delaware models,

¹⁰⁴ Guojin Chen, Yijun Zhang and Jing Wang, 'Resale Option, Inflation Illusion and the Chinese Stock Market Bubbles' (2009) 5 *Economic Research* 106, 106.

¹⁰⁵ Shanghai Stock Exchange Research Centre, *China Corporate Governance Report (2009)---The Market for Corporate Control and Corporate Governance* (Shanghai Stock Exchange, 2009) 112.

¹⁰⁶ Paul L Davies, 'The Notion of Equality in European Takeover Regulation' in Payne (ed), *Takeovers in English and German Law* (Hart Publishing 2002) 1.

¹⁰⁷ *Ibid* 1.

¹⁰⁸ Zhenhua Li, 'On the construction of the Legal Supervision System of Foreign-capital M&A' (2006) 6 *Journal of Hubei University of Economics* 120, 121.

¹⁰⁹ Shanghai Stock Exchange Research Centre, *China Corporate Governance Report (2009)---The Market for Corporate Control and Corporate Governance* (Shanghai Stock Exchange, 2009) 25.

refracted through distinctive national institutions.¹¹⁰ The rule that any post-bid defensive measures taken by target company boards should be approved by shareholders is similar to the UK system. At the same time, the requirement of directors' duties regarding the adoption of takeover defences is like the US system. Thus, it could be said the Chinese takeover regulatory system is a combination of the two. However, it is agreed by most scholars that China's takeover regulatory system is more like that of the UK, featuring a high level of state control.¹¹¹ Yet, China does not have a Takeover Panel to solve problems relating to takeover issues or regulate takeover defence measures, which the UK does. China only has organs under the jurisdiction of the CSRC, acting as advisory authorities, leaving the CSRC as the ultimate enforcement agent.¹¹² Moreover, it seems unlikely that Chinese courts will accept cases involving contests for corporate control without specific authorization from the Supreme People's Court, unless it is in the areas of Corporate and Securities Law, such as derivative suits and securities fraud litigation.¹¹³

¹¹⁰ John Armour, Jack B. Jacobs and Curtis J. Milhaupt, 'The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework' (2011) 52 *Harvard International Law Journal* 221, 275-276.

¹¹¹ Most of the Chinese journals accepted that China's takeover legislation system is derived from the UK's not the US's. See Xin Zhang, 'Shangshi Gongsi Shougou de Lifa he Jianguan -- Wo'men Wei Shenme Buneng Caiqu Meiguo Moshi [Takeover and Legislative Regulation: Why the American Approach is Disfavoured]' (2003) 8 *Securities Market Herald* 1, 8.

¹¹² John Armour, Jack B. Jacobs and Curtis J. Milhaupt, 'The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework' (2011) 52 *Harvard International Law Journal* 221, 274.

¹¹³ *Ibid* 274-275.

Even though the possibility of a market for corporate control in China seems more distant than for many other emerging countries, the hostile takeover of publicly-traded firms in China is ‘far from inconceivable’.¹¹⁴ China’s SOE-friendly approach has long been widely criticized.¹¹⁵ However, China has started to redefine her regulations to restructure SOEs and to change the capital market landscape:¹¹⁶ ‘The landscape is far different from 1990 when the first stock exchange, the Shanghai Stock Exchange, was launched. Most SOEs in monopoly industries, such as energy and telecommunications, are attempting to delist or reduce publicly traded shares from stock market in order to maintain more business secrecy and solidify state control.’¹¹⁷ As the Chinese economy and capital markets mature, the state may elect to relinquish control over some publicly-traded firms or industrial sectors.¹¹⁸ The central and local governments have also become more sophisticated in operating state assets and deem that less administrative interference and more market competition can promote the competitiveness of SOEs.¹¹⁹ To some extent, however, it is understandable that the state would wish to exert at least some control over those significant enterprises and industries it considers to be pillars of the national economy.

¹¹⁴ Ibid.

¹¹⁵ Charlie Xiao-chuan Weng, ‘Lifting the Veil of Words: An Analysis of the Efficacy of Chinese Takeover Laws and the Road to the Harmonious Society’ (2011) 24 *Columbia Journal of Asian Law* 181, 201.

¹¹⁶ Ibid 184.

¹¹⁷ Ibid 201.

¹¹⁸ John Armour, Jack B. Jacobs and Curtis J. Milhaupt, ‘The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework’ (2011) 52 *Harvard International Law Journal* 221, 274-275.

¹¹⁹ Jian Sun, ‘Jia Su Guo Qi Bing Gou Chong Zu Shi Chang Hua [The Ways of Expediting the Marketization of SOEs]’ (2009) 11 *Dong Shi Hui [Directors & Boards]* 63, 65.

This thesis will analyse whether the UK's takeover defence system is a better choice for China and discuss each major kind of takeover defence tactic to find out the possibility of legitimating them in China.

This thesis argues that the UK's takeover regulatory system is a better choice for China because of its pro-takeover element. However, China's regulatory system is becoming more of a combination of both the US and UK systems, because of new policies that make certain defence measures, like the poison pill, available to China's market. With China's market becoming more competitive and advanced, as long as the reform of China's SOEs continues, China's listed companies are likely to become attractive in the future. Therefore, it would be appropriate for China to legalise other defensive measures in order to assist the development of the market. The thesis proceeds as follows:

Chapter 2 starts with a theoretical discussion about the UK and US takeover regulatory systems. It summarizes the pros and cons of each. It concludes that the differences between China, the UK, and the US in terms of their market features and market players should be considered in judging which regulatory system is appropriate for China.

Chapter 3 discusses the differences in market structures and legal frameworks between China and the western countries. The special circumstances and problems that exist in China are discussed. This chapter highlights the concentrated share structure prevalent in China, which can result in the power to adopt takeover defences

belonging to one major shareholder, or the state. This is totally different to the UK and US, and even though Chinese government is trying to reform its shareholding structure, it is still a long way off. This discussion provides a basis for later consideration of each kind of takeover defence tactic. Directors' duties are also discussed, as tender offers present an inherent conflict of interest between managers and shareholders.¹²⁰ The managers' interests may not be aligned with that of the shareholders, insofar as if the takeover was to go through, there is a high possibility that they will be ousted from the control of the company.¹²¹ Consequently, whether the managers should have the power to defend against a takeover offer will be an important choice. Also, the different approaches taken to directors in the UK, US and China are discussed. As China takes a positive view towards promoting takeover activities, There is particular focus on the idea that giving control power to shareholders would be better for reducing the possibility that directors may act in their own interest.

Other problems that most Chinese listed companies may have are also discussed in this chapter. Firstly, the lack of takeover defence experience is considered. It is known that in many M&A undertakings, bidders do not obey takeover rules because takeover defence tactics are still fresh to Chinese listed companies. Control power is often abused by both bidders and target companies, as in the case of *Huajian*

¹²⁰ Ronald J. Gilson, 'A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers' (1981) 33 Stan L Rev 819, 819.

¹²¹ Ronald J. Gilson, 'A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers' (1981) 33 Stan L Rev 819, 891.

Electronic v Jinan Department Store, when the board of directors took defensive measures to frustrate the bidder's offer without the approval of the shareholders.¹²² Secondly, it is also pointed out that the current takeover defence legislation has many defects, such as an unclear legislative attitude, a lack of efficiency in supervision and enforcement, and the ambiguous content of related legislation.¹²³ Until China finishes its shareholding structure reform, it cannot be clearly known how many shares the government has in the stock market; however, the highly concentrated shareholding structure is analysed by way of background for subsequent chapters which discusses which takeover regulatory system fits China's market better.

The following chapters introduce reasons why China chose a UK-style takeover regulatory system instead of a US-style one. The discussion is based on a comparison of the UK and the US to find out under what conditions and in which kind of market these takeover defensive measures work, and whether these measures are too risky or not.

Chapters 4 to 6 examines three categories of takeover defence tactics. Chapter 4 covers takeover defence tactics relating to stock trading, including share repurchase tactics, the Pac-man defence and the white knight defence. Chapter 5 considers takeover defence tactics relating to management, including poison pills, the scorched

¹²² Yonghong Qiu, 'Guquan Zhuanrang Buneng Dongshihui Shuo De Suan--Dui Huajian Dianzi Shougou Jinan Baihuo de Falv Fenxi' (2001) <http://article.chinalawinfo.com/Article_Detail.asp?ArticleId=2266> accessed 26 April 2012.

¹²³ Shanghai Stock Exchange Research Centre, China Corporate Governance Report (2009)---The Market for Corporate Control and Corporate Governance (Shanghai Stock Exchange, 2009) 127.

earth policy, shark repellents, dual class recapitalization, cross-holding, seeking for the support of minority shareholders and institutional investors, greenmail and three kinds of ‘parachutes’ (golden, silver and tin). Chapter 6 discusses takeover defence tactics relating to litigation and other known defensive tactics, but focus largely on raising anti-trust issues, inadequate disclosure of information and crimes, as well as some less popular anti-takeover measures.

In each case, a definition is given, explaining the tactic’s function, and how they work to defend against a takeover. Each chapter also considers shortcomings in the operation of each defence tactic, as well as obstacles that may prevent their successful functioning. Based on this discussion, a conclusion is proposed as to whether that particular defence tactic should or could be adopted in China considering China’s economic and legal environment, as well as whether there exist any obstacles to legalising it or whether any problems will be caused by doing so.

Chapter 7 considers the legislative intent in China and then discusses why China chose a UK-style system and not a US-style system. One key reason is that China’s government is reluctant to delegate law making and enforcement power in critical economic policy areas to the courts, which are difficult to monitor and control centrally. Because China’s market is more regulatory than court-centred, any disputes solved by the court could only help to guide the resolution of relevant cases in the future without any enforcement power. Also, the UK’s regulatory approach could be more effective by providing rules and principles to relevant authorities to solve

takeover issues, and it could help the government to monitor market activities more effectively. Even if the government delegates law making power to the court, it will inevitably raise concerns about institutional competence and efficiency. Additionally, it is pointed out that the key reason that the US approach is unlikely to be replicated in other countries, even in advanced legal systems, is that 'it places extraordinary demands on the judiciary to respond, in real time and in full view of the capital markets, to legal issues deeply interwoven with complex business transactions where large sums of money are often at stake.'¹²⁴ The share price of the target company could be different every day during the takeover process, and if the authorities are not professional enough to deal with complex issues it might be harmful to the target or bidder company's shareholders' interest. Analysis of China's market, especially the existence of SOEs, is also provided in this chapter, to establish whether certain regulatory systems would work in China's market. Additionally, the principles and problems faced by China in regulating takeover activities are discussed.

Finally, chapter 8 summarises the thesis.

¹²⁴ John Armour, Jack B. Jacobs and Curtis J. Milhaupt, 'The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework' (2011) 52 *Harvard International Law Journal* 221, 283.

Chapter 2: Two major systems of takeover regulation

Executive summary

This chapter argues that different legislative systems have different rationales, and if China wishes to take reference from the UK or the US regulatory system, it must know the advantages and disadvantages of each in order to establish which is better for it. Thus, this chapter discusses the pros and cons of the UK and US systems to provide the basis for further discussion as to which system would be better for China in later chapters.

This Chapter is divided into three parts: the first introduces the UK's regulatory system; the second introduces the US regulatory system; and the third is a summary of conclusions. The former parts introduce each system via the (1) rationale and background to regulating takeover activities; (2) the advantages and disadvantages of each system; (3) an evaluation of each system.

First, however, there is an analysis of why the UK and the US started to regulate takeover activities and the point of view each adopted towards them. Both the UK and US have recognised that successful takeovers change the controlling power of a company. Even though the US and the UK both have a dispersed shareholding structure and relatively advanced market, their main shareholder groups are different: there have historically been more institutional investors in the UK's market who

preferred a statutory system in which they can exert control over the company, while the US originally had more retail investors, who did not trust institutional investors. Consequently, the judges made the US's regulation system director-friendly while the UK chose a shareholder-friendly takeover regulatory system. The UK's system has certain advantages, such as quicker, cheaper and more established procedures, equal treatment and procedural protection of shareholders, and effectiveness. Moreover, share premiums may be strengthened in a takeover-friendly regulatory system, and minority shareholders benefit from this. In terms of disadvantages, the British system has been criticized by scholars to be short-sighted and may be unhelpful for the long-term development of a company. The US regulatory system provides professional directors with more power to fight for greater premiums for shareholders as well as adopt sufficient remedies when problems arise so that the target could make a wise choice. However, the possibility of agency problems and the directors' self-interested actions have concerned scholars in that they could harm shareholders' interests.

Consequently, the UK and US approaches have been established based on analyses of their own market and the features of their typical market players. Therefore, the market features and political circumstances in China, as well as the western markets' features, should be considered when debating China's policy choice.

1. Introduction

Corporate governance is market-oriented in both the US and UK, and the largest corporations are characterized by a separation of ownership and control that is uncommon elsewhere in the world. Thus the distinguishing feature of the so-called “Anglo-American” system of corporate governance is that share ownership in public corporations is dispersed.¹²⁵ Each of the US and the UK has a common law orientation, unlike the civil law approach that characterizes many other countries. Each jurisdiction has had to face acute questions regarding the regulation of takeovers, such as whose interests should be protected and what responsibilities directors should have to shareholders.¹²⁶ These have been worked out over time.

When it comes to business and finance, the US and the UK arguably have more in common than any other pair of developed economies. Despite similarities in other areas of law, the US and UK have very different strategies for regulating takeovers, which is seen as the most prominent issue in all of corporate law. The divergences in US and UK takeover regulations are surprisingly deep. They represent two distinct takeover regulation modes. One is the UK’s self-regulating system and the other is the US’s judicial law-making system. It is argued by Armour and Skeel that the UK’s ‘self-regulation of takeovers has led to a regime largely driven by the interests of

¹²⁵ John Armour and Jr. David A. Skeel, ‘Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation’ (2007) 95 *Georgetown Law Journal* 1727, 1728.

¹²⁶ Sir Alexander Johnston, *The City Take-over Code* (Oxford University Press 1980) 13, 14.

institutional investors, whereas the dynamics of judicial law-making in the US have benefited managers by making it relatively difficult for shareholders to influence the rules.¹²⁷

An account of the differences in the development of the two systems suggests that the choice of rule-maker (whether judges or self-regulatory bodies) can be just as important an influence on the substance of takeover law as regulatory competition.

However, whether the current differences endure is an on-going question for the UK and the US. It can be imagined that the increasingly heterogeneous investment culture in the UK will undermine UK self-regulation, and that institutional shareholders in the US will press for a more shareholder-cantered approach in their system. Whether the substance of regulation is determined by their mode, and how, in turn, the differences in processes can be explained are interesting questions.¹²⁸

As seen, different countries are in favour of different merger control provisions and major differences arise from a few key factors, described by the OECD as follows:

¹²⁷ John Armour and Jr. David A. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 *Georgetown Law Journal* 1727, 1727.

¹²⁸ John Armour and Jr. David A. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 *Georgetown Law Journal* 1727, 1730.

... the criteria for defining or examining mergers,¹²⁹ the standards by which a merger is considered desirable or undesirable¹³⁰ and as regards procedure¹³¹...

Takeover regulation has a substantial influence in the world economy since takeover activities may transfer control of economic resources.¹³² Thus, it is important to review the basis of takeover regulations in both the UK and US and thereafter to establish which mode is more appropriate for China's market based on the review of these systems.

Moreover, the substance of takeover rules will affect shareholders' gains from the takeover activity.¹³³ That means, on one hand, that 'policy choice' will affect shareholders' gains from target corporations – i.e., whether they get a sufficient premium for their shares. It has been argued by Albert O "Chip" Saulsbury IV that the US legislation system will undoubtedly generate additional value for a company's shareholders due to the greater negotiating powers of directors in seeking a

¹²⁹ This could be explained as "size and market share thresholds". Cited from Organisation for Economic Co-operation and Development (OECD), *Merger policies and recent trends in mergers* (OECD 1984) 11.

¹³⁰ This could be explained as "a straightforward competition test or wider public interest criteria of which competition is but one, if important, element" cited from *ibid* 11.

¹³¹ This could be explained as "judicial or administrative or some combination of the two, prior or post notification, procedure for advance clearance or approval of certain mergers" cited from *ibid* 11.

¹³² Marco Ventoruzzo, 'The Thirteenth Directive and the Contrasts Between European and U.S. Takeover Regulation: Different (Regulatory) Means, Not So Different (Political and Economic) Ends?' Bocconi Legal Studies Research Paper No 06-07 page 7 <<http://ssrn.com/abstract=819764>> accessed 20 Jan. 2013.

¹³³ John Pound, 'The Effects of Antitakeover Amendments on Takeover Activity: Some Direct Evidence' in Patrick A Gaughan (ed), *Readings in Mergers and Acquisitions* (Blackwell 1994) 318.

higher-priced deal.¹³⁴ Hence, the policy choice made by the US increases shareholders' gainssur. On the other hand, shareholders' investment in bidder corporations should also be considered because if a bidding company takes over a target company, it could be seen that the shareholders in the bidding company will be indirectly invested in the target company after the takeover offer has been accepted. In this way, it could be argued that the US regulatory system makes it possible for a bidder company's shareholders to bear the risk of spending more money on taking over a target company which used takeover defensive measures to increase its premium. In the UK, the Takeover Code includes a strict timetable that all takeover activities must follow,¹³⁵ and within that limited timeframe it is possible that the shareholders of a bidder company may overestimate the value of a target's shares. Even in the US, since the directors are relatively free to employ defensive measures to negotiate a high premium for the target's shareholders, the interests of the bidders may be jeopardised if a bidder company accepts a target's share price, which may cause the bidder to pay more money for the target. Therefore if negotiating power is vested in directors, as in the US, shareholders in the bidder company may run the risk of a low return on their investment. Moreover, bidders' offers may help the undervalued company where there is high information asymmetry between the bidder and target companies in increasing the share price of the target company, and thus

¹³⁴ IV Albert O. "Chip"Saulsbury, 'The Availability of Takeover Defenses and Deal Protection Devices for Anglo-American Target Companies' (2012) 37 Del J Corp 115, 161.

¹³⁵ The Takeover Code (Eleventh edition) 2013 Rule 31.

bidders' gains could decline with the number of offers announced.¹³⁶ Consequently, the target company with low market capitalisation could get high returns from an announced bid.¹³⁷ It is therefore likely that takeover regulations will influence takeover frequency and thereafter have a sizeable impact on both the target and bidders' gains.

Scholars have pointed out that takeover regulations represent a kind of policy choice, such that the most important thing could be a focus on the wider economic impact of takeovers and on perfecting the regulatory system.¹³⁸ The following sections will focus on the UK and US regulatory systems and introduce the basis of regulating takeover defences to illustrate why legislators made their policy choices, and how the systems are different, by reviewing various scholars' works. Both systems will then be evaluated.

2. The UK system of takeover regulation

Armour and Skeel have observed that hostile takeovers first emerged in the 1950s,¹³⁹ and that professionals, especially institutional investors, avoided the need for *ex post*

¹³⁶ Paul Draper and Krishna Paudyal, 'Information Asymmetry and Bidder' Gains' (2008) 35 Journal of Business Finance & Accounting 376, 405. The authors did an empirical study on the relationship of information asymmetry, bid frequency, and bidder's gains, and found out the companies with high information asymmetry could benefit from the takeover offers.

¹³⁷ Ibid 392.

¹³⁸ Andrew Johnston, 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66 Cambridge Law Journal 422, 460.

¹³⁹ John Armour and Jr. David A. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 Georgetown Law Journal 1727, 1729-1730.

litigation by developing a body of norms, enforced by reputational sanctions, which ensured that contentious issues were resolved *ex ante* without the need for court involvement. The UK's statutory system was therefore driven by the preponderance of institutional investors in the marketplace, and a regulatory framework that trusted them to govern themselves.¹⁴⁰

1) Rationales & Regulations

The 1920s merger wave resulted in the transformation of the corporate economy from family-controlled businesses into modern large corporations in which ownership and control were separated¹⁴¹. The process advanced swiftly, and was largely complete between the 1950s and the end of the 1960s.¹⁴² Historically, a vast majority of companies were family-owned and managed. Although this kind of management could limit possibilities for expansion and inhibit the professionalization of management,¹⁴³ it could also allow companies to avoid the problems associated with

¹⁴⁰ John Armour and Jr. David A. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 Georgetown Law Journal 1727, 1730.

¹⁴¹ Andrew Johnston, 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66 Cambridge Law Journal, 422, 423.

¹⁴² Brian R. Cheffins, 'Mergers and the Evolution of Patterns of Corporate Ownership and Control: The British Experience' (2004) 46 Business History 256-284, the author argued that despite Hannah's claims to the contrary, the weight of evidence is that "personal capitalism" was not displaced by the 1920s merger wave. Instead, it began to be gradually unwound during the first half of the twentieth century, and the process accelerated after 1950, with the transition to big business largely complete by the end of the 1960s merger wave.

¹⁴³ A.D. Chandler, *Scale and Scope: The Dynamics of Industrial Capitalism* (Harvard 1990) 235-237, attributes Britain's weak economic performance to the persistence of "personal capitalism" and its incompatibility with the development of organizational capabilities.

the separation of ownership and control.¹⁴⁴ However, as the management structure evolved with the development of the market, such concentrated family-owned control over a corporation seemed to become less prevalent in the market. Thus the Greene Committee on Company Law recommended the introduction of the right for a bidder who had acquired 90 per cent of the shares to “squeeze-out” any remaining minority shareholders,¹⁴⁵ and section 155 of the Companies Act 1929 introduced the right for a purchaser whose offer had been accepted by a 90 per cent majority to force the remaining 10 per cent of shareholders to sell their shares on the same terms, with a right of appeal to the court on questions of value and oppression.¹⁴⁶ This provision proved to be absolutely fundamental to the emergence of the hostile takeover later in the 1950s, because it allowed bidders to acquire the entire share capital of its target, thereby preventing minority shareholders from free-riding on its efforts to improve efficiency.

¹⁴⁴ Andrew Johnston, ‘Takeover Regulation: Historical and Theoretical Perspectives on the City Code’ (2007) 66 Cambridge Law Journal 422, 423.

¹⁴⁵ *Report of the Company Law Amendment Committee* (1925-26 Cmd 2657), Part O Reconstruction and Amalgamation, para. 84-85.

¹⁴⁶ The S.155 Companies Act 1929 subsequently became the s.210 Companies Act 1948, then s.429 Companies Act 1985 and is now to be found in ss.979 et seq. Companies Act 2006. The Financial Services Act 1986 belatedly added the counterpart to this right to “squeeze out”: the right of minority shareholders to be bought out. Section 172 and Schedule 12 Financial Services Act 1986 and s.430A-C Companies Act 1985, which allows a minority shareholder who did not accept a bid to require a purchaser who has purchased over 90 per cent of the shares to buy their shares. This would prevent coercive bids – although the possibility of these is greatly restricted by the City Code, which requires equal treatment and information of shareholders – and also, more importantly, protects the small shareholder who may not have been paying attention when the takeover bid was made. The rules about a “sell out” can now be found in ss.983 et seq. of the Companies Act 2006. Cited in Andrew Johnston, ‘Takeover Regulation: Historical and Theoretical Perspectives on the City Code’ (2007) 66 Cambridge Law Journal 422, 425.

In the 1960s, a second large merger wave struck the UK, causing distinct changes. Further separation of ownership and control resulted and essentially enabled a group of professional administrative staff who were not shareholders to control a corporation.¹⁴⁷ That meant that the UK started to go into an era of managerial capitalism and its corporate governance improved at that time. Most companies performed better in the market and expanded their business thanks to professional management. At the beginning of the 1950s, some form of family control kept up the old standards in some of the largest UK firms, but there was a growing trend that ownership and control was better to be divorced in the developing market. In such cases where a company did not have a majority shareholder, management had a blank check, as shareholders could not overcome the collective action problem.¹⁴⁸

Bull and Vice explained the reason for the emergence of hostile takeovers in 1958 in detail as follows:

Firstly, there was a structural change in British industry. Production shifted ‘from textiles and heavy capital goods to aircraft, light electrical engineering and machine tools’.¹⁴⁹ Both income distribution and retailing also changed during that time, which helped raise consumption.

¹⁴⁷ L. Hannah, *The Rise of the Corporate Economy* (2nd ed. edn, London 1983) Ch. 10 196.

¹⁴⁸ Brian R. Cheffins, ‘Dividends as a Substitute for Corporate Law: The Separation of Ownership and Control in the United Kingdom’ ((2006) European Corporate Governance Institute Law Working Paper No69/2006).

¹⁴⁹ G. Bull and A. Vice, *Bid for Power* (3rd ed. edn, 1961) 29.

Secondly, a large portion of the corporate profits were taken by a dramatically-increased tax burden, so corporations might not have funds for future development if directors did not reduce the amount of profit distributed to shareholders.¹⁵⁰

Furthermore, companies were leaning towards spending surplus cash on the replacement of assets in times of high inflation. Generally speaking, the share price should keep pace with the value of the companies' assets, yet, the share price at that time could not keep up with the growth of companies' profit-earning assets because of the reduction in distribution to shareholders caused by the aforementioned constraints.¹⁵¹ Thus, the share price was much less expensive than the asset value of the company, which provided a rare opportunity for hostile bidders to expand their business.

As a result, between 1952 and 1955, a great 'boardroom revolution' happened in the UK, as the livelihood of corporate managers was threatened by suddenly-emergent hostile takeovers.¹⁵² Hostile takeovers would be seen as a threat by the current board of directors with the possibility of their being replaced, so that the directors, to certain extent, would have to put shareholders' interests ahead of their own when executing deals regarding takeovers, as directors are given 'both power and protection

¹⁵⁰ Ibid 30.

¹⁵¹ R. W. Moon, *Business Mergers and Takeover Bids* (3rd edn, London 1968) 125.

¹⁵² Andrew Johnston, 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66 Cambridge Law Journal 422, 428.

commensurate with their interest in corporate affairs'.¹⁵³ Shareholders already had the right to appoint or remove a board of directors, to attend meetings, and obtain information on the performance of the company, and these rights seemed sufficient for non-professional dispersed shareholders to manage a company by themselves. This could also prevent time-consuming collective action problems and help to maximise a company's value or even, more broadly, society's wealth.

It is also argued by proponents of the agency model that defensive measures were devices by which managers could sacrifice shareholders' benefits to secure their own positions in a company, and that social welfare might even be reduced.¹⁵⁴ If a board was permitted by litigation to take defensive tactics to deal with a hostile takeover offer, it could be predicted that more bids would fail because of said defensive measures, making defensive measures a threat to the takeover mechanism. Furthermore, if the directors could decide whether or not to adopt takeover defence measures, this could delay or prevent prospective takeovers and reduce the number of potential bidders. Thus, the market of corporate control may not work as well as in the market whose takeover activities are encouraged.¹⁵⁵ Accordingly, a lively market needs a legislation system that limits the viability of takeover defensive measures taken by directors.

¹⁵³ Henry G. Manne, 'Mergers and the Market for Corporate Control' (1965) 73 *Journal of Political Economy* 110, 112.

¹⁵⁴ F. Easterbrook and D. Fischel, *The Economic Structure of Company Law* (Cambridge, Mass. 1991) 173, 174.

¹⁵⁵ *Ibid.*

Consequently, both the use of deal protection devices and takeover defences by the directors have been strictly prohibited by the UK's regulatory authorities since 1968,¹⁵⁶ thus the directors in UK companies do not have abundant negotiating power to decide over the sale of their company, making hostile takeovers more viable.

These factors have also affected the attitude towards hostile takeovers of the law-makers at that time in the UK, and helped lead them to adopt a shareholder-friendly regulatory system. The following sections will briefly introduce the UK's regulatory development and discuss its pros and cons.

a. A brief introduction to why takeover regulation occurred

With respect to litigation, the UK adopted a different approach from that of the US. This is largely due to three main reasons: the first is an optimistic opinion of takeover activities, the second is the identity of majority shareholders, and the other is different attitude towards the concern of agency cost.

In 1959, the Issuing Houses Association and other associates¹⁵⁷ took the first step towards producing regulations to conduct takeover activities in the UK.¹⁵⁸ As takeover activities emerged in the UK market, the balance of opinion was that “the

¹⁵⁶ IV Albert O. "Chip" Saulsbury, 'The Availability of Takeover Defenses and Deal Protection Devices for Anglo-American Target Companies' (2012) 37 Del J Corp 115, 117.

¹⁵⁷ These include the Accepting Houses Committee, the Association of Investment Trust, the British Insurance Association, the Committee of London Clearing Bankers and the London Stock Exchange. Cited from Sir Alexander Johnston 19.

¹⁵⁸ Sir Alexander Johnston, *The City Take-over Code* (Oxford University Press 1980) 19.

process is a natural one and, since it is generally based on the best utilisation of physical capacity, managerial experience and available labour, it has almost always proved to be in the national interest... (And) it is therefore important that it should continue and should not be artificially impeded.”¹⁵⁹ More importantly, regulators shared similar views to scholars, such that the UK’s legislation comes originally from a perspective of favouring takeover bids.

As mentioned, the UK has many institutional investors in its market as majority shareholders in companies, who are assumed to have the ability to make their own decisions regarding takeover issues. In the UK, this statutory system was principally orchestrated by the community of investment bankers and institutional investors; corporate managers were not a well organized demographic, and, compared with the American system, had little say in the formulation of the regulatory approach. As a result, it is unsurprising that the rules were primarily designed to protect the shareholders’ interests.¹⁶⁰

In addition, since there is always a concern regarding agency cost in dealing with major company issues, the majority shareholders, as institutional investors, would rather trust themselves over directors to take the final decision. Both *Hogg v. Cramphorn Ltd.*¹⁶¹ and *Howard Smith Ltd. v. Ampol Petroleum Ltd.*¹⁶² established

¹⁵⁹ Ibid 20.

¹⁶⁰ John Armour and Jr. David A. Skeel, ‘Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation’ (2007) 95 Georgetown Law Journal 1727, 1731.

¹⁶¹ *Hogg v. Cramphorn Ltd.* [1967] Ch. 254, [1966] 3 All E.R. 420.

that the question of the purpose of deploying takeover defence measures by directors must be established before the question of the effect of the decision on the shareholders' rights - or the viability of a takeover - is addressed.¹⁶³ In neither case was it in any doubt, based on the evidence, that the board's motivations had been improper, but in every case the question of propriety is a matter of fact and of evidence.¹⁶⁴ In this way, mistrust between the managers and the shareholders have the potential to be a big issue, because the shareholders are possible to believe that the directors did not act in the company's or the shareholders' best interest just because they have different ideas of these company issues.

In October 1959, Notes on Amalgamations of British Business (Notes) was published which established takeover regulations' principles and distinguished principles from procedure.¹⁶⁵ The Notes delegate power to the shareholders to decide whether to sell their company or not, and suggests no interference in the free market. The principles the Notes set forward provided the basis for the future takeover regulation of UK. Shortly after the Notes were released, the Board of Trade set out Licensed Dealers' (Conduct of Business) Rules (Rules) in August 1960. These establish the meaning of a "takeover offer" and are "a most effective and useful guide to the proper conduct of

¹⁶² *Howard Smith Ltd. v. Ampol Petroleum Ltd.* [1974] A.C. 821, P.C., [1974] 1 All E.R. 1126, a case on appeal to the Privy Council from the Supreme Court of New South Wales.

¹⁶³ Andrew Johnston, 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66 Cambridge Law Journal 422, 440.

¹⁶⁴ *Ibid* 440.

¹⁶⁵ Sir Alexander Johnston, 'The City Take-over code' in (Oxford University Press 1980) 20 The Notes do not provide too much detail regarding procedures but outline some general principles for practitioners to follow when they are dealing with takeovers.

takeover offers”.¹⁶⁶ In 1963, the Notes were revised in a more logical order,¹⁶⁷ and in 1968 the Panel was established to issue and administer the City Code on Takeovers and Mergers.¹⁶⁸

b. Features of related regulations

At present, UK takeover activities are regulated by three major instruments. The first is the EU Directive on Takeover Bids (EU Directive), which sets out “minimum standards across the European Union for the regulation of takeover bids”.¹⁶⁹ The second is the Companies Act 2006, which established how to regulate the manager’s actions, liabilities, compensation and other related rules, since both bidder companies and target companies involved in all takeover activities should obey the rules that the Companies Act sets. The third, and most important one, is the City Code on Takeovers and Mergers (the Code), the details of which regulate UK takeover activities, encompassing both principles and the procedures.

The first piece of legislation is the EU Directive. The EU Directive drew reference from the UK’s approach to regulating takeover activities; hence it encourages the board of directors to remain neutral in its actions.¹⁷⁰ But the EU Directive sets an

¹⁶⁶ Ibid 24.

¹⁶⁷ Chapter IV: First City Code and Panel in Sir Alexander Johnston, *The City Take-over code* (Oxford University Press 1980) 30-50.

¹⁶⁸ The Takeover Code 2013, overview and section 4(a).

¹⁶⁹ The Takeover Panel, *The European Directive on Takeover Bids* (Aug 2005) 2; EU Directive -- Directive 2004/25/EC of the European Parliament and of the Council, Art. 1.1.

¹⁷⁰ EU Directive -- Directive 2004/25/EC of the European Parliament and of the Council, Art. 3.1(c).

optional ‘breakthrough rule’¹⁷¹ to neutralize some of the takeover defensive measures in the event of hostile offers. However, few member states implement it. Meanwhile, the Directive is trying to harmonise the laws within EU countries and limit the ability of the controlling group to entrench its position and fend off appropriate offers.¹⁷²

The UK City Code on Takeovers and Mergers is the major regulation relating to the takeover activities within the UK. Experts have generally lauded it as a system of self-regulation that offers the advantages of speed, flexibility and low-cost administration.¹⁷³ Many of its provisions are uncontroversial and reflect a consensus view about the way in which takeovers should be carried out. However, the Code’s prohibition on defensive measures by management in the event of a takeover is far more controversial.¹⁷⁴

¹⁷¹ EU Directive -- Directive 2004/25/EC of the European Parliament and of the Council, Art. 11: “Where, following a bid, the offeror holds 75 % or more of the capital carrying voting rights, no restrictions on the transfer of securities or on voting rights referred to in paragraphs 2 and 3 nor any extraordinary rights of shareholders concerning the appointment or removal of board members provided for in the articles of association of the offeree company shall apply; multiple-vote securities shall carry only one vote each at the first general meeting of shareholders following closure of the bid, called by the offeror in order to amend the articles of association or to remove or appoint board members. To that end, the offeror shall have the right to convene a general meeting of shareholders at short notice, provided that the meeting does not take place within two weeks of notification.”

¹⁷² Marco Ventoruzzo, ‘The Thirteenth Directive and the Contrasts Between European and U.S. Takeover Regulation: Different (Regulatory) Means, Not So Different (Political and Economic) Ends?’ Bocconi Legal Studies Research Paper No 06-07 <<http://ssrn.com/abstract=819764>> accessed 20 Jan. 2013 63.

¹⁷³ Andrew Johnston, ‘Takeover Regulation: Historical and Theoretical Perspectives on the City Code’ (2007) 66 Cambridge Law Journal 422, 422.

¹⁷⁴ Ibid 422.

The City Code consists of six General Principles and 38 rules and is far more comprehensive than the Revised Notes. The Code required comparable treatment of shareholders of the same class, equality of information to all shareholders and that the offeree board must provide their shareholders with their opinion on the bid. The incumbent board's opinion would be of considerable importance to target shareholders because of their detailed knowledge of the position and prospects of the business, and so, when combined with the common law duty, this provision of fair treatment to all the shareholders in the City Code¹⁷⁵ considerably improved the ability of target company shareholders to make informed decisions. Common law was not well equipped to impose affirmative duties of disclosure on directors, particularly given that it does not in general impose fiduciary duties on directors towards individual shareholders.¹⁷⁶ Rule 25.1 of the current version of the City Code requires the Board of the offeree to provide offeree shareholders with the board's opinion of the offer together with the independent advice they have received. The Rule also details a number of issues that their opinion should consider and requires reasons to be given for the opinion.¹⁷⁷ This could help with preventing certain issues happening

¹⁷⁵ It is stated by Andrew Johnston in 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66 Cambridge Law Journal 422, 442 that "the Code required similar treatment of shareholders of the same class, equality of information to all shareholders and the offeree board to provide their shareholders with their opinion on the bid." And see *Gething v. Kilner* [1972] 1 All E.R. 1166, [1972] 1 W.L.R. 337.

¹⁷⁶ Andrew Johnston, 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66 Cambridge Law Journal 422, 442.

¹⁷⁷ Ibid 442 note 98.

during the takeover process, and aimed to regulate takeover activity in detail with the Panel providing more professional and effective help.

Thus it could be said that the introduction of the City Code effectively prevented a flow of litigation to the English courts.¹⁷⁸ It also said that the City Code prohibits activities that hinder takeovers, which are swiftly and pre-emptively dealt with by the Takeover Panel.¹⁷⁹

2) Advantages

The City Code has been amended frequently, except for its key provisions. In 2004, the European Takeover Directive¹⁸⁰ was made to harmonise the rules of takeovers in the European Union and it set certain principles for the member states to follow and some optional arrangements for the member states to reserve the rights in implementing some rules.¹⁸¹ At that time, the UK Parliament passed legislation putting the Panel on a statutory footing for the first time, and the terms to enforce that were included in the Companies Act 2006. These terms of enforcement functioned as an authorization for the Panel to lay punishment directly on law-offenders, which is a sustainable advantage in keeping with a statutory approach.¹⁸²

¹⁷⁸ The Howard Smith case was exceptional, arising from an appeal to the Privy Council from the Supreme Court of New South Wales. Cited from *ibid* note 90.

¹⁷⁹ *Ibid* 441.

¹⁸⁰ Directive 2004/25/EC of 21 April 2004 (O.J. 2004 L142/12) .

¹⁸¹ *Ibid*, a.12.

¹⁸² Section 952 Companies Act 2006 gives the Panel power to impose sanctions on wrongdoers. Before this, the Panel had to rely on public censure of wrongdoers or on the FSA, which had endorsed

Moreover, it is noted that the UK system has *prima facie* advantages over the US system because the former's procedures seem to be much 'quicker, cheaper, and more certain' than the latter system, which relies upon litigation.¹⁸³ However, whether and to what extent takeover defensive measures should be permitted when a target company receives a hostile offer remain issues discussed by scholars. According to Armour and Skeel's research, the City Code's "no frustration action rule" seems to be based on the available empirical findings evidence.¹⁸⁴

In particular, the City Code is perceived to benefit dispersed shareholders, as it provides equal treatment, and some procedural protection, to shareholders. These protections also required practitioners to follow the ethical standards while performing their managerial duties.¹⁸⁵

The influence of the City Code was so substantial that it utterly altered the UK's system of corporate governance. Because of its prohibition of defensive tactics when targets receive a hostile offer, it is claimed that managers were forced to focus on short-term value for shareholders and minimise general management discretion.¹⁸⁶

the City Code under s143 of the Financial Services and Markets Act 2000, taking action at its request against "authorized persons". Cited in Andrew Johnston, 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66 Cambridge Law Journal 422, 447 note 112.

¹⁸³ John Armour and Jr. David A. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 Georgetown Law Journal 1727, 1732.

¹⁸⁴ Ibid.

¹⁸⁵ Andrew Johnston, 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66 Cambridge Law Journal 422, 449.

¹⁸⁶ Ibid 422, 460.

The introduction of the City Code could therefore be said to have been good for corporate governance and received broad support from economists from a financial point of view.¹⁸⁷

There is a mandatory bid rule in the City Code that ensures all shareholders get a controlled premium. This provision can also prevent creeping acquisitions of control as well as encourage portfolio diversification. Thus, individual investors could control the level of risk of their investments. All takeover activities cost bidders a certain amount of extra money to pay the premium to all of the target company's shareholders, meaning there may be fewer takeover bids as fewer potential bidders could afford such a cost; ultimately, this would potentially mean be fewer changes in corporate control.¹⁸⁸ It is understandable that shareholders, especially minority shareholders, are more concerned with their share premiums than the management of the company, hence this could maintain investors' confidence to invest in the target company. The current management, to some extent, could improve because of the threat of removing them if a hostile bid is successful.

3) Disadvantages

¹⁸⁷ F. Easterbrook and D. Fischel, *The Economic Structure of Company Law* (Cambridge, Mass. 1991) 171, 172; Brian R. Cheffins, *Company Law: Theory, Structure, and Operation* (Oxford 1997) 62, 64; J. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Oxford 1993) 54, 56.

¹⁸⁸ Andrew Johnston, 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66 *Cambridge Law Journal* 422, 451.

In terms of the disadvantages of the UK's regulatory system, it is argued that the City Code – and the prohibition on defensive measures in particular – was introduced because Common Law had demonstrated itself incapable of putting in place a system of takeover regulation that ensured takeovers remained a viable means of ensuring managerial accountability to shareholders. It also raised the question of how best to protect against the most competent controlling shareholders' abuse of their rights when deciding to sell the company. That is to say, how to protect minority shareholders, given the knowledge gap between these shareholders and the controlling shareholders.¹⁸⁹

The UK Takeover Code strips the board of any ability to use takeover defences and now prohibits the use of deal protection devices.¹⁹⁰ Instead, the authority to decide on the merits of a transaction rests solely with the shareholders of the company. By eliminating defences, the revised Takeover Code significantly reduces the board's negotiating power and reduced the premiums for the shareholders.¹⁹¹

It could be said that the market for corporate control is the product of explicit choices rather than natural forces,¹⁹² and it may be true that 'policy choices' are made in the

¹⁸⁹ Marco Ventoruzzo, 'The Thirteenth Directive and the Contrasts Between European and U.S. Takeover Regulation: Different (Regulatory) Means, Not So Different (Political and Economic) Ends?' Bocconi Legal Studies Research Paper No 06-07 <<http://ssrn.com/abstract=819764>> accessed 20 Jan. 2013 78

¹⁹⁰ The Takeover Code (Eleventh edition) 2013 Rule 21.

¹⁹¹ IV Albert O. "Chip" Saulsbury, 'The Availability of Takeover Defenses and Deal Protection Devices for Anglo-American Target Companies' (2012) 37 Del J Corp 115, 161.

¹⁹² Andrew Johnston, 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66 Cambridge Law Journal 422, 459.

pursuit of better corporate governance and to better profits for shareholders. However, scholars have claimed that the regulations focus less on the benefits of bidder shareholders, employees, and other stakeholders¹⁹³ and more on an expedient takeover process.¹⁹⁴

4) Evaluation: why this system is appropriate for the UK

Even if there are many considerations that informed takeover regulation, only the aforementioned Notes reference litigation over frequently used defensive measures taken by boards of directors. In fact, what the courts have pursued is a way to resolve disputes by applying pre-existing directors' duties. The Common Law approach sets out the fiduciary duties of directors and grants managers considerable discretion to make decisions as motivated by a proper purpose. Thus there is no fundamental difference between decisions taken to adopt takeover defensive measures and other managerial decisions.¹⁹⁵ It is true that the detailed examination of the purposes behind a decision fits the existing managerial system of company law very well, but it also brings considerable uncertainty and delay from the investor's point of view.

¹⁹³ Ibid 459.

¹⁹⁴ According to the timetable in the City code, all the preparation of the offer usually should be completed within no more than 60 days and a decision on whether to accept or refuse the offer should be made within this timeframe as well, lest there arise some excuses to extend the timetable, such as another bidder interested in taking the company coming forward. See: The Takeover Code 2013 Rule 31.6.

¹⁹⁵ Johnston explained that: "Through the courts' application of the proper purpose rule, managerial decisions that could be construed as defensive measures in response to takeovers were regulated no differently from any other managerial decisions." In Andrew Johnston, 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66 Cambridge Law Journal 422, 436.

Thus, it has been said that “there was a danger that litigation itself could become a potent defensive measure.”¹⁹⁶

There is also a mandatory bid rule in the UK in order to protect minority shareholders by listing the circumstances when the bidding company should make a general offer. The Code requires that “when a mandatory offer is required and who is primarily responsible for make it except with the consent of the Panel, when: (a) any person acquires...an interest in shares which (taken together with shares in which persons acting in concert with him are interested) carry 30% or more of the voting rights of a company.”¹⁹⁷ This rule complements the equal treatment principle of the Takeover Code which states that “all holders of the securities of an offeree company of the same class must be afforded equivalent treatment; moreover, if a person acquires control of a company, the other holders of securities must be protected”¹⁹⁸. Thus, the requirement for a mandatory bid ensures that a premium is paid for the acquisition of control.

At the same time, the equal treatment aspect ensures that all minority shareholders benefit from that premium.¹⁹⁹ Common Law had not insisted on equal treatment of shareholders, as sales of shareholdings were considered a private matter with no implications for those outside the contract. Thus, when a bidder could purchase a

¹⁹⁶ Ibid 436.

¹⁹⁷ Rule 9.1, The Takeover Code (Eleventh edition) 2013.

¹⁹⁸ General Principle 1, The Takeover Code (Eleventh edition) 2013.

¹⁹⁹ Andrew Johnston, ‘Takeover Regulation: Historical and Theoretical Perspectives on the City Code’ (2007) 66 Cambridge Law Journal 422, 446.

controlling shareholding or a large minority block in a private sale before launching a takeover bid, the remaining shareholders would find that their shares were valued on the basis of being a minority stake only.²⁰⁰ However, the Takeover Code provided sufficient protection for all the shareholders during a takeover activity by having the equal treatment rule. Equal treatment guaranteed all the shareholders were treated fairly and all of them would have an opportunity to oppose a takeover. The equal treatment of shareholders is manifest not only in the equal price of shares, but also the information disclosed about the takeover activity.²⁰¹

It is also claimed by scholars that, in terms of content, nothing has changed since the Directive was implemented – although some of the Code’s provisions now have Parliamentary approval. The dominant theoretical view of the City Code remains that it is both a regulatory solution to a market failure,²⁰² and that it ensures managerial accountability to shareholders without creating externalities for third parties. Shareholders are conferred the right to decide whether to accept the offer of selling their shares at a premium or to refuse the offer and trust the current managers when they are faced with a bid.

²⁰⁰ Andrew Johnston, ‘Takeover Regulation: Historical and Theoretical Perspectives on the City Code’ (2007) 66 Cambridge Law Journal 422, 446.

²⁰¹ Rule 20.1 The Takeover Code (Eleventh edition) 2013.

²⁰² In the case of the Code this would be correcting the market outcome that minority shareholders do not share in the takeover premium because of the possibility of creeping acquisitions, which in turn would discourage investors from diversifying their portfolios. Cited in Andrew Johnston, ‘Takeover Regulation: Historical and Theoretical Perspectives on the City Code’ (2007) 66 Cambridge Law Journal 422, 448 note 120.

More importantly, the Takeover Code placed a higher requirement on directors' fiduciary duties than the common law by "embodying in a particularly clear way the principle that, during the course of a takeover bid, directors of the target company are meant to act as the agents of the shareholders",²⁰³ whereas Company Law only requires directors "to act within [their] powers and to promote the success of the company for the benefit of its members as a whole", which afford inadequate protection to a target company's shareholders.²⁰⁴ It was suggested, however, that the protection of minority shareholders would be improved if the law required directors to promote the success of the company in order to "benefit the members" rather than "the company as a whole".²⁰⁵ Thus, the Takeover Code stipulates a non-frustration rule in Rule 21 to make sure directors will not do anything to frustrate a takeover offer without the shareholders' approval.²⁰⁶ Consequently, this stipulation, and the mandatory bid rule both serve the principle of equal treatment to all shareholders in order to protect their rights; this protection could be an improvement over previous attempts because of its limiting the risk of the directors acting according to their own priorities when dealing with takeover offers.

²⁰³ Simon Deakin and others, 'Implicit Contracts, Takeovers and Corporate Governance: in the Shadow of the City Code' (2002) ESRC Centre for Business Research, University of Cambridge Working Paper 254 <<http://www.cbr.cam.ac.uk/pdf/WP254.pdf>> accessed 11 December 2012, 14.

²⁰⁴ Jonathan Mukwiri, 'Implementing the Takeover Directive in the UK' (DPhil thesis, University of Leicester 2008) 75.

²⁰⁵ John Parkinson, *Corporate Power and Responsibility* (Clarendon Press 1993) 77.

²⁰⁶ The Takeover Code (Eleventh edition) 2013 Rule 21.

At the same time, as discussed before, minority shareholders' typical focus is on amount of premium, rather than managerial accountability, and takeover activities, especially hostile takeovers, could help fulfil the minority shareholders' desire to receive a higher premium. Thus, letting the shareholders decide whether to accept a hostile takeover offer or not could be the best way for the minority shareholders to achieve their aim. Even though the City Code is criticised for only focusing on maintaining the majority shareholders – i.e., institutional investors' – confidence by giving these shareholders the power to choose to defend against a takeover offer or not historically, it did help promote the operation of a market for corporate control and could benefit minority shareholders as well.²⁰⁷ Thus it could be said that the UK's takeover regulatory system fits the British market properly, since the UK has both a large number of institutional investors and many minority shareholders.

3. The US system of takeover regulation

The US system of takeover regulation has mainly been influenced by four major sources: the Delaware law, the Williams Act, standards when dealing with hostile takeovers provided by some cases and the state antitrust law. It is, in a sense, more complicated than the UK system because each state has its own legislative authority. Even though there are some connections between each of them, as major principles are followed by every state in respect of regulating economic activities, differences do

²⁰⁷ Andrew Johnston, 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66 Cambridge Law Journal 422, 451.

exist among them. Data show that more than 50% of all US publicly-traded companies and 63% of the Fortune 500 are incorporated in Delaware, therefore Delaware Law is by far the most important source of regulation in the US.²⁰⁸ Therefore, this section will focus on discussing the development of Delaware's laws and consider other states' regulations only where specifically relevant.

1) Rationales & Regulations

Takeover regulation in the US is totally different from in the UK, and this is evident in the absence of self-regulation in the US. The UK's statutory system emerged because major shareholders are usually institutional investors and they can be trusted to have the experience to take crucial decisions regarding their company themselves. Most investors in the US, however, are different. There are few institutional investors who own a similar proportion of listed shares in the US as in the UK. Most American investors, at least at the time when legislators sought to regulate takeover activities, were retail investors who did not trust the "insiders" within financial institutions to control the company in their interests; thus, the UK's statutory system is not preferred by US shareholders.²⁰⁹

Regulating takeovers in the US began much earlier than the emergence of Delaware's takeover cases in the 1980s, even though scholars often mention them

²⁰⁸ The State of Delaware, 'About Agency' (14 Nov 2012)

<<http://corp.delaware.gov/aboutagency.shtml>> accessed 09 Dec 2012.

²⁰⁹ John Armour and Jr. David A. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 Georgetown Law Journal 1727, 1731.

simultaneously.²¹⁰ A series of New Deal reforms of banking and securities law in the 1930s laid the foundation for US takeover regulation, and after 30 years, hostile takeovers began to emerge. At that time, both the reform of Delaware's corporate law and amendments to the securities laws of the Williams Act were passed by Congress. These legislative developments were influenced by the 1930s reforms and the final decision was taken to leave the takeover regulation to Delaware courts.²¹¹

a. Brief introduction of why regulation of takeovers occurred

The 1933 and 1934 Securities Acts were passed in the wake of the 1929 Crash and the early years of the Great Depression, and sought to correct the perceived market abuses of the 1920s by imposing new disclosure and antifraud regulations.²¹²

To conduct a hostile takeover, two methods were often used: the first is a proxy contest, and the other is a hostile tender offer. The proxy contest is conducted by insurgents to persuade other shareholders to vote on "contested issues and board seats" in order to change the controlling group in the company, while a tender offer is made directly by a bidder to other shareholders, indicating the desire to buy their shares to

²¹⁰ John Joseph Wallis, 'The New Deal' available at http://econweb.umd.edu/~wallis/oup_newdeal_FTE.pdf accessed 21 Jan 2013.

²¹¹ Andrew N. Vollmer, Andrew E. Nagel, and Paul R.Q. Wolfson, 'The Williams Act: A Truly "Modern" Assessment' (*Harvard Law School Forum on Corporate Governance and Financial Regulation*, 22 Oct 2011) <http://www.wilmerhale.com/pages/publicationsandNewsDetail.aspx?NewsPubId=88579> accessed 23 Jan 2013.

²¹² John Armour and Jr. David A. Skeel, 'Who Rights the Rules for Hostile Takeovers, and Why? -- The Recular Divergence of US and UK Takeover Regulation' (2007) 95 *Georgetown Law Review* 1727, 1752.

control the company.²¹³ Its use of proxy contest can be dated to 1954, when Robert R. Young²¹⁴ launched a hotly contested and ultimately successful proxy contest²¹⁵ for control of the New York Central Railroad, which was viewed as an assault on the existing norms of Wall Street behaviour and discouraged public challenges to corporate directors.²¹⁶ However, proxy contests were not an effective mechanism to obtain control of the company, because their success depended greatly on a bidder's persuasive powers and the extent of a company's shareholders' dissatisfaction. Instead, in the late 1950s and early 1960s, corporate raiders found another useful mechanism — the tender offer.²¹⁷

Soon after the introduction of the tender offer, in the late 1960s, merger and acquisition activities intensified, so regulators in the US made a series of important reforms to make the legislative framework fit the new market. Most reforms had an effect on legislation that lasted until the end of the 1990s; the most significant was the

²¹³ Uma V. Sridharan and Marc R. Reinganum, 'Determinants of the Choice of the Hostile Takeover Mechanism: An Empirical Analysis of Tender Offers and Proxy Contests' (1995) 24 *Financial Management* 57, 65.

²¹⁴ Eli F. Goldston, 'Robert R. Young: The Populist of Wall Street' (1969) 43 *The Business History Review* 586, 586. Robert Young "gained control of the Alleghany Corporation; until his suicide in 1958, he was a major force in the Eastern railroad situation...he pioneered the development of the public proxy battle with appeals."

²¹⁵ A proxy contest is an event when the stockholders of a corporation develop opposition to some aspect of corporate governance. It often focuses on directorial positions. Robert Young's case is a very well known and successful one. See Frank D. Emerson and Franklin C. Latham, 'Proxy Contests: Competition for Management Through Proxy Solicitation' (1954) 8 *Sw L J* 403, 405.

²¹⁶ Ron Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (1990) 508-511.

²¹⁷ John Armour and Jr. David A. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 *Georgetown Law Journal* 1727, 1734.

expansion of the powers of a company to indemnify its directors. This change was made by the 1976 amendments to Delaware's General Corporation Law, which also reviewed self-interested transactions, included a provision authorizing 'cash-out mergers',²¹⁸ and reduced the availability of appraisal rights.²¹⁹

Although none of the major changes were directly aimed at the emergence of hostile takeover bids, the managers' frequently raised proposal to reform takeover legislation was finally taken into account by legislator. Expanded indemnification provided more protection against the possibility of fiduciary duty litigation and more protections were provided for directors when exercising their rights.²²⁰

By the 1980s, most takeover defence tactics had been tested in the market and had been judged proper or not by the Delaware courts: when target companies were facing

²¹⁸ A cash out merger refers to "the merger of a target firm paid in cash by the buying firm, which occurs when the targeted firm's stockholders or shareholders do not want any part of ownership of the buying firm by stock as a result of the merger". Definition from Black's law dictionary online < <http://thelawdictionary.org/cashout-merger/>> accessed 24 Jan 2013.

²¹⁹ S. Samuel Arsht & Walter K. Stapleton, 'Delaware's New General Corporation Law : Substantive Changes' (1967) 23 Bus L 75 90 and according to Sec 262 of Delaware General Corporation Law, 'appraisal rights' means "(a) Any stockholder of a corporation of this State who holds shares of stock on the date of the making of a demand pursuant to subsection (d) of this section with respect to such shares, who continuously holds such shares through the effective date of the merger or consolidation, who has otherwise complied with subsection (d) of this section and who has neither voted in favour of the merger or consolidation nor consented thereto in writing pursuant to § 228 of this title shall be entitled to an appraisal by the Court of Chancery of the fair value of the stockholder's shares of stock under the circumstances described in subsections (b) and (c) of this section."

²²⁰ John Armour and Jr. David A. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 Georgetown Law Journal 1727, 1754.

a hostile bidder,²²¹ nearly all of the most important cases would make their way through the Delaware courts – even though Delaware’s pre-eminence as the leading state of incorporation had started to fade since the 1960s.²²²

The ground rules that defined how 1980s takeover bids were structured were put in place by the other major 1960s reform, the Williams Act. In its original incarnation, as introduced by New Jersey Senator Harrison Williams in 1965, the Bill would have made it unlawful for a bidder to acquire more than 5% of a target company’s stock “until the expiration of twenty days after such person has sent to the [target company], and has filed with the [SEC] a statement” describing, among other things, “the background and identity of all persons”.²²³

In 1968²²⁴, Congress passed the Williams Act, the aim of which was to “protect individual shareholders when there are corporate raiders who are attempting to take over their stocks of the target company²²⁵ by addressing the bidder’s information

²²¹ Frank Reynolds, ‘Eroded’ Takeover Law Favors Directors, Delaware’s Chief Business Judge Says’ (14 Apr 2011)

<http://newsandinsight.thomsonreuters.com/Legal/Insight/2011/04_-_April/_Eroded__takeover_law_favors_directors,_Delaware%E2%80%99s_chief_business_judge_says/> accessed 25 Jan 2013.

²²² John Armour and Jr. David A. Skeel, ‘Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation’ (2007) 95 Georgetown Law Journal 1727, 1753-1754.

²²³ S.2731: A Bill Providing for Fuller disclosure of corporate Equity Ownership of Securities under the securities Exchange Act of 1934, 89th Cong. 1st Sess. at 2-3 (Oct 22 1965) cited in *ibid*.

²²⁴ William Magnuson, ‘Takeover Regulation in the United States and Europe: An Institutional Approach’ (2009) 21 Pace Int’l L Rev 205, 213.

²²⁵ Andrew N. Vollmer Andrew E. Nagel, and Paul R.Q. Wolfson, ‘The Williams Act: A Truly "Modern" Assessment’ (Harvard Law School Forum on Corporate Governance and Financial Regulation, 22 Oct 2011)

disclosure duties and setting up some procedure requirements”.²²⁶ Specifically, the Williams Act required bidders to disclose certain information, including their background and identity, the source of funds, the purpose of the takeover, etc.,²²⁷ when the bidder obtained more than five per cent of a target’s shares²²⁸. Moreover, the Act gave the shareholders of the target company the right to withdraw tendered shares in the first seven days of the tender offer, in addition to other articles pertaining to share price that protected shareholders’ benefits.²²⁹

Thus, the Williams Act helped prevent bidders from conducting a so-called “Saturday night special” tender offer to push shareholders to make a decision on tendering their shares and “make the offer available on a first come, first served basis”.²³⁰ Meanwhile, directors of target companies were restrained by their fiduciary duties as

<<http://www.wilmerhale.com/pages/publicationsandNewsDetail.aspx?NewsPubId=88579>> accessed 23 Jan 2013 5.

²²⁶ William Magnuson, ‘Takeover Regulation in the United States and Europe: An Institutional Approach’ (2009) 21 Pace Int’l L Rev 205, 213.

²²⁷ Ibid 213.

²²⁸ Andrew N. Vollmer Andrew E. Nagel, and Paul R.Q. Wolfson, ‘The Williams Act: A Truly “Modern” Assessment’ (Harvard Law School Forum on Corporate Governance and Financial Regulation, 22 Oct 2011)

<<http://www.wilmerhale.com/pages/publicationsandNewsDetail.aspx?NewsPubId=88579>> accessed 23 Jan 2013 5.

²²⁹ Note, ‘The Developing Meaning of “Tender Offer” under the Securities Exchange Act of 1934’ 86 Harv L Rev 1250, 1254, 1260. Other requirements include “requires the bidder who raises its bid price to pay the higher price even to shareholders who tendered at the lower price; requires that the offer be kept open at least forty days; and prohibits fraud by either side in a tender offer campaign.”

²³⁰ John Armour and Jr. David A. Skeel, ‘Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation’ (2007) 95 Georgetown Law Journal 1727, 1755.

interpreted by the American courts when dealing with an offer.²³¹ In addition, shareholders could consider the offer over a proper time period, and would not be penalised if they withdraw their tendered shares. Thus, it could be said that the Williams Act gave shareholders more protection in takeover activities.

In 1985, many defensive tactics were employed by directors,²³² until the poison pill and other defensive measures were challenged by some institutional investors to increase the likelihood of a tender offer succeeding.²³³ At that time, there was a sharp increase in the frequency of takeover activities such as had not happened since the great merger wave at the end of the Gilded Age.²³⁴ Most managers used a variety of defensive tactics to fight hostile bidders; one of the most influential was the poison pill,²³⁵ developed by Marty Lipton who was a co-founder of New York's Wachtell Lipton.²³⁶ The Delaware Supreme Court also issued landmark opinions on regulating defensive measures. For example, in the case of *Moran v. Household Int's, Inc.*, the

²³¹ William Magnuson, 'Takeover Regulation in the United States and Europe: An Institutional Approach' (2009) 21 Pace Int'l L Rev 205, 214-218.

²³² Alexander R. Sussman and Arthur Fleischer Jr., 'Directors' Fiduciary Duties in Takeovers and Mergers' (31st Annual Securities Regulation Institute) available at <http://www.friedfrank.com/siteFiles/ffFiles/sri_directors_duties.pdf> accessed 1 July 2015 page 9.

²³³ Duane A. Stewart, 'Whose Corporation is It, Anyway?: The Contrasting Models of Corporate Control in Pennsylvania and Delaware Viewed Through "Poison Pill" Jurisprudence' (2001) 27 Ohio NU L Rev 97, 116.

²³⁴ John Armour and Jr. David A. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 Georgetown Law Journal 1727, 1755.

²³⁵ Poison pill is a right plan. The poison pill is triggered by certain conditions such as a pre-specific percentage of shares bought by the hostile bidder and gave the target's shareholders certain rights. It will be discussed in Chapter 5 in detail.

²³⁶ Chase deKay Wilson, 'Marty Lipton's Poison Pill' (1984) 3 Int'l Fin L Rev 10.

court held that “the poison pills are not per se impermissible, despite the fact that they discriminate between the tender offer bidder and other shareholders of the target company”.²³⁷

Additionally, there were several cases that promoted the development of Delaware takeover regulations and helped establish directors’ duties and general principles when dealing with the takeover bids. In *Unocal Corp. v. Mesa Petroleum Co.*,²³⁸ judges established a two-part test for directors on deciding whether to adopt defensive measures against a hostile bid. First, that the defensive tactics should be employed to an threat to the target company and second, that the directors needed to prove they were acting in good faith in respect of corporate governance and had conducted reasonable investigations to believe the offer was a danger to current corporate policy and effectiveness.²³⁹ Consequently, the poison pill was accepted by the court as a feasible takeover defensive measure in the US.

Once a hostile bid was in process, directors’ duties changed, as determined in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*²⁴⁰ Directors were permitted to use

²³⁷ *Moran v. Household Int’l, Inc.* 500 A.2d 1346(Del. 1985).

²³⁸ *Unocal Corp. v. Mesa Petroleum Co.* 493 A.2d 946(1985).

²³⁹ William Magnuson, ‘Takeover Regulation in the United States and Europe: An Institutional Approach’ (2009) 21 Pace Int’l L Rev 205, 215.

²⁴⁰ *Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.* 506 A.2d 173 (1985).

defence tactics to get the highest possible price for shareholders once shareholders had decided to sell the company, or the company would be broken up.²⁴¹

At the end of the 1980s, more than 40 states enacted takeover defence legislation that was almost the same as the Delaware style that protected directors of companies in employing takeover defensive measures. Moreover, almost every state legislature gave target companies' managers "new tools for resisting unwanted takeover bids".²⁴² That said, it is difficult to find any systematic research on whether other states still follow Delaware's standards.

b. Features of related regulations

US takeover legislation has some specific features, as will be detailed. Firstly, directors are fully bonded by their fiduciary duties in running the day-to-day business affairs under Delaware corporation law, and their duties were enhanced in excising their power of controlling the corporation when facing a hostile offer under the *Unocal* and *Revlon* standards.²⁴³ Secondly, Delaware law allows the directors of a target company to employ a variety of takeover defensive tactics if they believe that a hostile offer poses a threat to the current corporate governance of the target company and will not have good prospects for the benefit of shareholders in the future.

²⁴¹ John Armour and Jr. David A. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 *Georgetown Law Journal* 1727, 1727.

²⁴² *Ibid.*

²⁴³ Michal Barzuza, 'The State of State Antitakeover Law' (2009) 95 *Virginia Law Review* 1973, 1975.

Moreover, there is a constituency statute that allows the directors to frustrate a takeover bid to protect stakeholders when they think the takeover would infringe the stakeholders' interest in most states in the US.²⁴⁴ The most famous example is the invention of the poison pill as a defensive measure, a tactic that was, subsequently, widely used in the US – but only the classic version of the poison pill is accepted.

To be specified, Delaware law prevents a hostile bidder from completing a back-end merger²⁴⁵ with a target company for three years after buying more than 15% of a target's shares unless: 1. The bidder gains approval of the target board in advance; 2. The bidder goes from less than 15% ownership of the target to more than 85% ownership in a single tender offer; or 3. The bidder gains approval from two-thirds of the disinterested shares after buying more than 15%.²⁴⁶ Section 203 of the Delaware General Corporation Law (DGCL) was enacted in 1988, providing the bidders a “meaningful opportunity for success”.

The UK's takeover regulation was influenced by tax, at first, as mentioned in the previous section; it has also been argued that the incentive for regulating Delaware

²⁴⁴ C Hansen, 'Other Constituency Statutes: A Search for Perspective' (1991) 46(4) The Business Lawyer 1355, Appendix A for a list of laws.

²⁴⁵ “The transaction to eliminate the minority shareholders is often called a back-end merger or mop-up merger. The terms of a back-end merger may be significantly less attractive than the terms of the original offer.” That is to say a back-end is a merger in which a buyer will acquire all the target company's shares following the merger. See Robert W. Hamilton and Richard A. Booth, *Attorney's Guide to Business and Finance Fundamentals* (2nd edn edn, Wolters Kluwer 2006) 13-16.

²⁴⁶ Guhan Subramanian and Steven Herscovici and Brian Barbetta, 'Is Delaware's Antitakeover Statute Unconstitutional?' (2009-2010) 65 Bus Law 685, 687.

takeovers was also influenced by franchise tax structures.²⁴⁷ In addition, the development of US takeover regulations “depended upon the accumulation of common law precedents”, while the UK’s were motivated by the needs of the market.²⁴⁸ US judges could only make decisions in cases already presented to them; thus the evolution of US takeover law was highly dependent upon judges having to settle disputes. Whether directors or shareholders could take advantage of litigation seems to be decided on the basis of the specific group of litigants – “which group is better-organized or funded than the others, the content of the law may be expected to develop in a manner favourable to their interests”.²⁴⁹ Accordingly, US takeover regulations clearly benefit managers more than shareholders since “they had enough time to wage an effective campaign against a hostile bidder”.²⁵⁰ It is also hard for bidders to succeed in a hostile bid as there are various defensive measures that directors can use to defend against their offers.

2) Advantages

²⁴⁷ Michal Barzuza, ‘Delaware's Compensation’ (2008) 94 Virginia Law Review 521, 521.

²⁴⁸ Armour and Skeel assessed the US regulatory framework, analysed primary and secondary materials from the New Deal era, studied the legislative history of the 1968 Williams Act and primary materials charting the 1967 amendments to the Delaware General Corporation law, researched contemporary newspaper accounts, and drew from a variety of other sources. See John Armour and David A. Skeel, ‘Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation’ (2007) 95 Georgetown Law Journal 1727, 1729-1731.

²⁴⁹ Ibid 1730.

²⁵⁰ Ibid 1.

The US enjoys the efficiencies of having one language, one country and one market across a continent,²⁵¹ and thus US takeover regulations are in one sense, less complicated. As stated, in the US, half of all publicly-held companies are incorporated in Delaware, and the debate over antitakeover law has therefore focused almost exclusively on Delaware law.

It is true that the availability of takeover defensive tactics and deal protection devices in Delaware corporate law gives managers of the target companies more negotiating power to fight for a higher premium for shareholders in takeover activities than that in the UK,²⁵² and that some empirical studies show the advantages of US legislation in this respect.²⁵³ Since most of directors of target companies are professionals and are experienced in corporate governance, but most shareholders are not, directors could provide shareholders with an expert analysis of a bidder's offer and enable them to make a more informed choice on whether to accept the offer. Thus, the onus of negotiating power on directors could reasonably let these professionals generate additional value for a target company's shareholders.²⁵⁴

Even if directors cannot be totally trusted not to take any defensive measures in their own interest, there are remedies provided by Delaware law. In fact, Delaware law

²⁵¹ A. Turner, *Just capital* (Macmillan 2001) 154-157.

²⁵² IV Albert O. "Chip" Saulsbury, 'The Availability of Takeover Defenses and Deal Protection Devices for Anglo-American Target Companies' (2012) 37 Del J Corp 115, 115.

²⁵³ Michal Barzuza, 'The State of State Antitakeover Law' (2009) 95 Virginia Law Review 1973, 1982.

²⁵⁴ IV Albert O. "Chip" Saulsbury, 'The Availability of Takeover Defenses and Deal Protection Devices for Anglo-American Target Companies' (2012) 37 Del J Corp 115, 161.

requires higher standards of directors when they are dealing with an offer. In order to prevent directors abusing their negotiating rights to fight against a hostile bid, accepting a lower bid by managers simply with the reason of better long-term prospects is forbidden by the Delaware law. It would require rather the directors accept the highest bid for the shareholders than picking the lowest one with such reasons if the company is inevitably be taken over by the bidder.²⁵⁵ In addition, if the directors did refuse an offer because of the threat of being removed by the bidder, shareholders still have the right to sell the company.²⁵⁶ More importantly, it is criticised by the scholars that the constituency statute has negative effect on the shareholders' interest in companies incorporated in the states passing the stakeholder constituency statute in the US.²⁵⁷

Directors are restrained by their fiduciary duties to a company, so it is reasonable to trust directors nominated to manage the company. Section 203 of DCGL encourages a 'fair deal' for all shareholders, and its primary strength is that it forces a bidder to pay "for the inherent value of the corporation".²⁵⁸ Thus it could be predicted that shareholders at least would not be selling their company at a loss in the short-term.

²⁵⁵ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* 506 A.2d 173, 182 (Del. 1986). Also see discussions about the Revlon duty in Michal Barzuza, 'The State of State Antitakeover Law' (2009) 95 Virginia Law Review 1973, 1986.

²⁵⁶ Andrew Johnston, 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66 Cambridge Law Journal 422, 460.

²⁵⁷ John C. Alexander, Michael F. Spivey and M. Wayne Marr, 'Nonshareholder Constituency Statutes and Shareholder Wealth: A Note' (1996) 3 Journal of Banking & Finance, 417, 432.

²⁵⁸ Peter L. Tracey, 'The Delaware Debate on Takeover Legislation: No Small Wonder' (1989) 93 Dick L Rev. 339, 365.

On top of these advantages, deal protection devices attached to a merger agreement could be a “signal to the market that the company is an attractive target”²⁵⁹ such that it may attract more new bidders to a target company to choose a favourable bidder. Delaware law adopts less target protections, because there were relatively few potential target companies located in Delaware (most of the companies are major American corporations).²⁶⁰ Thus, if target protection is too strong, there will be no possibility for the existence of hostile bids, which will not help the development of the market. Indeed, the availability of takeover defence tactics could be seen as target protection, to some extent, and seems to be adequate for the target to fight against the hostile bidder or find a best offer.

3) Disadvantages

As discussed in Chapter 1, the potential of agency costs in the US may be more self-evident compared with the UK, because US directors have the power to take defensive measures against a hostile takeover offer and there is a very clear danger of self-interest tainting the actions of directors. That means that the threat of a breach of fiduciary duties by directors still exists. Any defensive response must ultimately permit the existing board to be replaced, if it should fail to deliver, through proxy

²⁵⁹ IV Albert O. "Chip" Saulsbury, 'The Availability of Takeover Defenses and Deal Protection Devices for Anglo-American Target Companies' (2012) 37 Del J Corp 115, 159.

²⁶⁰ Guido Ferrarini & Geoffrey P. Miller, 'A Simple Theory of Takeover Regulation in the United States and Europe' (2009) 42 Cornell Int'l L J 301, 345-346.

machinery.²⁶¹ The primary purpose for which the directors used their powers may be for shareholders' benefit, but directors may nonetheless adopt improper defensive measures, for example because they were directly motivated by maintaining their positions on the board or their control over the company.²⁶² However, if the aim of frustrating actions against the corporate raiders was to protect business plans, this could be good for the company, and even the community in which it is based, and such actions should be allowed.

As noted above, Section 203 of the DGCL is different to other provisions in the US because it details some restrictions on abusing takeover defensive measures.²⁶³ However, an empirical study has shown some defects in that provision. The study was conducted between January 1988 and December 2008 and revealed the following: firstly, over that 21-year period, no bidder necessitated the applicability of Section 203 as a condition to their offer; secondly, no bidder's holding shares went from less than 15 per cent to more than 85 per cent in a singer tender offer in these years, results which reflect an inconsistency with the claims of the proponents of Section 203; and

²⁶¹ Janice Dean, 'Directors' Duties in response to hostile takeover bids' (2003) 14 *International Company and Commercial Law Review* 370, 372.

²⁶² Andrew Johnston, 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66 *Cambridge Law Journal* 422, 440.

²⁶³ Stephen P Lamb and Jeffrey M. Gorris, 'A Practical Response to a Hypothetical Analysis of Section 203's Constitutionality' (2010) 65 *Bus Law* 771, 771.

thirdly, that “no bidder ‘busted through’ and suffered the three-year moratorium on a business combination that Section 203 requires”.²⁶⁴

More importantly, it was found that acquisitions may “reduce the managerial slack by replacing inefficient management”; thus, the takeover activities could constrain directors to work in shareholders’ interests and keep the market more competitive.²⁶⁵

The availability of the takeover defensive tactics within the US regulatory system may reduce the number of takeovers; hence this system stems the market’s development. Moreover, shareholders in the US complain of being treated unequally in respect of some takeover defences, such as “greenmail” or “poison pills”, and the US’s directors’ positions seems to be more secure than it is in the UK. These factors have attracted criticism from researchers because they reduce the accountability of a board in adopting defensive measures as well as the power of shareholders to remove the board in a proxy contest.²⁶⁶

4) Evaluation: why this system is appropriate for the US

Regarding US takeover regulation, it is said that a jurisdiction’s laws should facilitate takeover bids while restricting the possibility of two major conflicts — “the conflict of interest between managers and shareholders, and of interest between majority

²⁶⁴ Guhan Subramanian and Steven Herscovici and Brian Barbetta, ‘Is Delaware’s Antitakeover Statute Unconstitutional?’ (2009-2010) 65 Bus Law 685, 687.

²⁶⁵ Roberta Romano, ‘A Guide to Takeovers: Theory, Evidence and Regulation’ (1992) 9 Yale J on Reg 119, 129.

²⁶⁶ P. L. Regan, ‘What’s Left of Unocal’ (2001) 26 Delaware Journal of Corporate Law 947, 947.

shareholders and minority shareholders”.²⁶⁷ US takeover regulations could be said to successfully satisfy these primary goals, as in *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware court established the rules to test whether directors have proven reasonable grounds “by showing good faith and reasonable investigation”²⁶⁸ to defend against a takeover offer while there is a conflict of interest between directors and the shareholders.

In addition, even though there is no legislation like the EU Directive to guide US takeover regulation, they have nonetheless been significantly affected by anti-trust law.²⁶⁹ In the US, however, the absence of restrictions on defensive measures that may be employed to repel a hostile bid is questionable.²⁷⁰ Moreover, the debate regarding antitakeover legislation has been claimed to have significant influence on its economy.²⁷¹

The existence of strict SEC requirements and greater possibilities for “delaying” litigation than in the UK, as well as the absence of a mandatory bid rule, make hostile takeover bids in the US risky. Charter amendments to “stagger” board changes or

²⁶⁷ William Magnuson, ‘Takeover Regulation in the United States and Europe: An Institutional Approach’ (2009) 21 Pace Int’l L Rev 205, 208.

²⁶⁸ *Unocal Corp. v. Mesa Petroleum Co.* 493 A.2d at 955.

²⁶⁹ James A. Fairburn & John A. Kay (ed) *Mergers and Merger Policy* (Oxford 1989) 232.

²⁷⁰ Marco Ventoruzzo, ‘The Thirteenth Directive and the Contrasts Between European and U.S. Takeover Regulation: Different (Regulatory) Means, Not So Different (Political and Economic) Ends?’ Bocconi Legal Studies Research Paper No 06-07 <<http://ssrn.com/abstract=819764>> accessed 20 Jan. 2013 5.

²⁷¹ Michal Barzuza, ‘The State of State Antitakeover Law’ (2009) 95 Virginia Law Review 1973, 2039.

authorise preferred stock issues to “friendly” parties are widely accepted in the US as legitimate defence tactics.²⁷² These measures will hinder the taking of control over a target company.

In terms of questions about breaches of fiduciary duties by directors, it is said that the US does not practice an unrestrained free market in relation to hostile takeover bids.²⁷³ Defences are sometimes allowed where appropriate and directorial discretion is subjected to safeguards. This may protect business developments for the longer term at the expense of premiums for target company shareholders. Accordingly, the US, to some extent, does set a series of principles that directors should follow and gives directors a limited freedom to decide the future of the company – whether to sell, or refuse the premium that the bidder offered. This could be a good reference for regulating takeover activities as well.²⁷⁴

Additionally, a main consideration in the Delaware courts’ decisions to allow managers to use defensive tactics was that shareholders have a safety value – i.e., their voting rights. Thus, should managers be faced with a hostile takeover and try to block shareholders from exercising their voting rights, Delaware courts require them to meet an almost impossible standard: they have to convince the court that there was a compelling justification for preventing shareholders from exercising their voting

²⁷² Janice Dean, ‘Directors’ Duties in response to hostile takeover bids’ (2003) 14 *International Company and Commercial Law Review* 370, 372.

²⁷³ *Ibid* 377.

²⁷⁴ *Ibid* 377.

rights.²⁷⁵ This could be seen as a protection for shareholders in preventing directors from breaching their duties to safeguard their rights. However, the focus is on the process of informing the board, not necessarily on the merits of the decision, which is where the similarities of the two regulatory systems end. While the US gives directors a great deal of autonomy in deciding on the merits of a deal, the UK gives this power to shareholders.²⁷⁶ No one can guarantee whether a hostile takeover offer will benefit a target company's shareholders in the long run, however, and there could be takeover offers which may benefit the shareholders in the short-, but not the long-term. Thus it could be a risky choice for the decision makers whether to sell the company or not and if the directors have the power to make the decision, it is not hard to find a good reason to convince US authorities that they are acting in shareholders' interests. Consequently, it could be possible that directors may use takeover defensive measures *de facto* on the basis of their own interest rather than the shareholders' in the US, and the shareholders have to take the risk of premium losses. At the same time, even if the US has tried its best to prevent the directors to act in their own interest, it is criticized by David Millon that "shareholder primacy is not a legal doctrine".²⁷⁷ It is argued "corporate law ends up being irrelevant to the crucial question of corporate purpose

²⁷⁵ *Blasius Industries, Inc. v. Atlas Corp.* 564 A.2d 651(1988) the court said: "In two recent cases dealing with shareholder votes, this court struck down board acts done for the primary purpose of impeding the exercise of stockholder voting power. In doing so, a per se rule was not applied. Rather, it was said that, in such a case, the board bears the heavy burden of demonstrating a compelling justification for such action."

²⁷⁶ Michal Barzuza, 'The State of State Antitakeover Law' (2009) 95 Virginia Law Review 1973, 1987.

²⁷⁷ David Millon, 'Shareholder Primacy in the Classroom After the Financial Crisis' (2013) 8 J. Bus. & Tech. L. 191, 192.

and management's responsibility, leaving them largely within the discretion of management itself".²⁷⁸ Thus it could be said that the prevention of directors acting for their own interest could be less effective as Delaware law desires. In the UK, however, shareholders can make their own decision whether to take that risk or not, provided that directors offer objective advice to them.

4. Conclusion

The UK and the US are both good examples of systems that regulate takeover activities: their lawmakers duly considered the market features, differences between their markets and the developmental directions of their markets before making regulations in order to make sure they would fit their market and cooperate with corporate governance improvement. Thus, these two distinctive regulatory systems could work well in either market and have improved gradually during their development. If China wants to have a proper takeover regulatory system, these factors should also be valued; otherwise it is hard to say the regulatory system would work. Furthermore, there is another principal factor that will shape takeover regulation – the differences in the political power of market players.²⁷⁹ In China, this might influence takeover activities more than it does in western countries due to the existence of state-owned companies. Therefore, in the following chapters, political differences will also be discussed as different levels of political power on the part of

²⁷⁸ Ibid 195.

²⁷⁹ Guido Ferrarini & Geoffrey P. Miller, 'A Simple Theory of Takeover Regulation in the United States and Europe' (2009) 42 *Cornell Int'l L J* 301, 301.

market players could possibly lead to an unfair market and make takeover regulations hard to implement.

In addition, the anti-trust impact on takeover regulations cannot be ignored: firstly, “the links between industrial concentration and the danger of monopolistic pricing”²⁸⁰ are a possible result of a successful takeover transaction, and secondly, merger policy has been particularly influenced by economic analysis²⁸¹ and all efforts put into regulating the market are for a better economic performance of companies and a better economic order. These factors should be considered when designing the regulation of takeover activities.

Despite the different approaches that the US and UK take in regulating M&A activities, the substantive requirements for directors’ approval is almost identical. In addition, the general powers and duties of American and British directors parallel one another.²⁸² Both jurisdictions require directors of a target company to approve merger transactions. In both the US and the UK, the incentive of the directors’ business decisions is always the key point when analysing the actions of directors during the sale of company, and courts generally give deferential treatment to directors. More importantly, directors in the US, under *Smith v. Van Gorkom*²⁸³ in Delaware and

²⁸⁰ George Hay, ‘Mergers & Merger Policy’ in James A. Fairburn & John A. Kay (ed), *Mergers and Merger Policy* vol 8 (Oxford 1989) 232.

²⁸¹ Ibid 232.

²⁸² IV Albert O. "Chip" Saulsbury, ‘The Availability of Takeover Defenses and Deal Protection Devices for Anglo-American Target Companies’ (2012) 37 Del J Corp 115, 129.

²⁸³ *Smith v. Van Gorkom*, 488 A.2d 858 (Del.1985).

those in the UK under the Takeover Code have a duty to be adequately informed and must seek the advice of independent financial advisors on the adequacy of the offer.

In addition, both sets of takeover regulations become increasingly bidder-friendly with increasing geographic scope²⁸⁴ and, within jurisdictions, reflect the respective political interests of bidder and target firms. In the UK, there is a uniform regulatory system to provide guidance about takeover activities, while in the US, situations are more complicated, as they must reference both federal and state law, and each US state has different regulations. Resultantly, solutions to the same takeover issue could be different between different states.

Overall, all western legislation and the law of the state of incorporation on takeover activities provides a good reference for China in order to better enable her to perfect her own legislation. To achieve that, one should also consider the principal factors mentioned at the beginning of this section, and the anti-trust influence on merger policy, as well as some special conditions of China's market. Thereafter, this regulation could be expected to be a good and appropriate one, which might work well in the Chinese market and help maximizing the benefits for participants in a takeover transaction.

²⁸⁴ Because there are more and more cross-border takeovers taking place across the globe.

Chapter 3: Background to regulation of takeovers and comparative study of UK, US and China: comparisons of shareholding structures, market features and legislative frameworks

Executive Summary

This chapter will further the discussion of China's circumstances compared with those of the US and UK in order to establish whether certain takeover defensive measures could work in China, and which system China should adopt in terms of anti-takeover regulations. Whilst the last chapter focused more on political and social reasons behind the UK and US regulatory systems, this chapter will consider legal and economic factors to establish the differences between China and the western markets and reveal the difficulties of simply transplanting a western-style regulatory system into China.

To compare the US, UK and Chinese markets, this chapter will first consider the differences in ownership structures between the three countries. Both the UK and the US have highly dispersed shareholding structures; the UK has more institutional investors, and the US has more non-financial investors. China's market has a highly concentrated ownership structure with a distinct 'Yigu Duda' problem, because the state indirectly holds a large percentage of shares in SOEs. Even though China enacted shareholding structure reform, the problem of concentrated ownership still exists and might be the main issue in seeking to transplant western laws to China.

This chapter will also compare the histories of the three markets and outline that the UK and the US have international and more advanced markets with long histories of development, while China's market is still young and needs much more work to develop. Thus, the western markets are currently more effective than China's. It is also argued that the share price of companies in the Chinese market does not reflect the real value of its companies. In addition, the western markets give shareholders more power, but China's immature market does not protect minority shareholders' rights as well as majority shareholders'.

This chapter will also discuss the varying legal frameworks of these countries and explain how much of China's takeover legislation is drawn from each of the US's and UK's systems. The chapter notes that there are rules in China which only exist in name, with the state having too much power in the market because of the large percentage of shares it owns. The UK and the US have well developed legal frameworks and supervisory authorities to regulate and watch over the market. In case of disputes, they can provide good protection for shareholders. The main concern in these countries is the protection of minority shareholders because of the dispersed shareholder structures they have. China's legal system still lacks experience and relevant legislation, however. Corporate governance and supervision problems are still serious issues in China's market and the development of China's legal regimes in regulating takeover activities has not caught up with the developmental pace of the market, so the law cannot yet solve all the problems that emerge. In addition, the supervisory body, the CSRC, is not free from the government to provide independent

supervision over the market and needs to improve the quality of its supervision of the market.

Consequently, due to the existence of these differences between China and the western countries, not all law that has worked well in western countries will also work well in China. Thus any attempt at transplanting certain takeover defensive measures to China should first consider these differences and analyse whether they would fit China's market or not.

1. Introduction

The regulation of takeover activities matters to future practice. China's market is distinctive. Factors that should be considered in the design of a proper regulatory framework are as follows: what is the legislators' attitude towards takeover activities? Can the institutional investors' judgement be trusted? How can the interests of conflicted groups in a transaction (such as minority and majority shareholders; shareholders and directors) be balanced? And how might the on-going reform of SOEs change the highly concentrated shareholding structure? The new Chinese government is still working on reforms and will issue a plan as to how to continue these reforms in the near future.

Takeover defensive tactics may reduce the likelihood of M&A activities to some extent, and might also protect very valuable listed companies from hostile takeover.

At present, most Chinese companies only use anti-trust law as a defence to fight against hostile offers, with no, or few, other measures taken by target companies except for asking for governmental help in seeking judgements regarding monopolization, and that is why China still requires regulation for takeover defence tactics.

Historically, Chinese SOEs tried to raise funds from the Hong Kong stock market in the 1990s, when the Chinese authorities were persuaded by financial experts to adopt the regulations then used in Hong Kong.²⁸⁵ In addition, the members who drafted Mainland China's takeover regulations consulted Hong Kong experts in their law making process; thus, the influence of Hong Kong's takeover regulations is strong.²⁸⁶ As Hong Kong was a colony of the United Kingdom until 1997, Hong Kong's legal system is based on a British legal regime. This is one reason why China's takeover legal system chose a British-style system initially. Also, since creating a totally new regulation or legislation in a new area could be time-consuming for China then, and at that time China do not have sufficient experience in regulating a stock market with the backward economy. Moreover, since the takeover regulation worked well in Hongkong and the UK, localize this relatively mature regulation system into China's

²⁸⁵ Guanghua Yu, 'Does One Size Fit All? Transplanting English Takeover Law into China' in Cheryl R. Lehman (ed), *Corporate Governance: Does Any Size Fit? Advances in Public Interest Accounting*, vol 11 (Elsevier Ltd 2005) 49, 52.

²⁸⁶ Wei Cai, 'The Mandatory Bid Rule in China' (2011) 12 *European Business Organization Law Review* 653, 655.

new market would be appropriate and it would help China focus on developing its economy.

However, transplanting a western regulatory system into Mainland China is not such an easy thing because of the different market structure, legal systems, and even cultures that may have some effects on transplanted laws. One thing to be noted is that “the effectiveness of the various functions of the takeover regulation depend on the corporate governance systems they are part of”,²⁸⁷ in that takeover regulation can significantly influence the efficiency of a market. It is therefore necessary to discuss the development of the markets and relevant legislation, in the UK, US, and China. This can facilitate an understanding of how and why some regulations work in specific markets, which is important to establish in assessing which regulatory system will work for China and, as a result, which way China should go with her market and system of legislation. This chapter will therefore introduce the features of these three markets through an explanation of how these markets developed and what the characters of these markets are. China’s highly concentrated shareholding structures will also be discussed. Discussion will focus on a comparison of the legal frameworks of these three countries. In each case, regulation was intended to solve certain issues, which arose during a certain period, so no one system can fit where the same kind of market and a similar legal framework do not exist. Following the analysis and

²⁸⁷ Marc Goergen, Marina Martynova and Luc Renneboog, ‘Corporate Governance Convergence: Evidence from Takeover Regulation Reforms in Europe’ (2005) 21 *Oxford Rev of Econ Policy* 243, 268.

comparison of these three countries, the discussion of multiple forms of defensive tactics will be conducted in subsequent chapters.

2. Different ownership structures and markets

The markets of the US, the UK and China are not the same. They have each enjoyed unique developmental histories and have different shareholding structures. Thus, to find out which rules are most suitable for each market, it is useful to know something about the features of each of them.

1) Differences in ownership structures

a. UK and the US's ownership structures

Both the UK and US have highly dispersed shareholding structures, but research shows that the patterns of share ownership are different for each country.²⁸⁸ According to Short and Keasey, institutional investors occupy a large proportion of the total UK shareholdings, while in the US, most shares are held by households - one of the non-financial sectors. Institutional investors are said to be more active in corporate governance because there are fewer restrictions in the UK. In the US, restrictions on institutional investors are far more stringent, to prevent individuals from holding too large a stake in an individual company, also raising the cost to

²⁸⁸ Helen Short and Kevin Keasey, 'Managerial Ownership and the Performance of Firms: Evidence from the UK' (1999) 5 *Journal of Corporate Finance* 79, 82.

financial institutions of participating in corporate governance.²⁸⁹ Whether dispersed shareholding ownership is beneficial or not is disputed, but research has suggested that there may be a connection between dispersed shareholding ownership and the emergence of takeover activities. That is, the emergence of takeover activities may have pushed the development of both the US and the UK's shareholding structures gradually.²⁹⁰

As discussed in the previous chapter, the timeline of merger waves is highly similar to the timeline of the transition of both the UK and the US ownership structures from family-oriented to a more dispersed set-up. Scholars have concluded that the takeover process was crucial to the evolution of the ownership and board control of British companies.²⁹¹ The US ownership structure started its transition from the end of 19th century to the beginning of 20th century, and the US merger wave emerged at almost the same time.²⁹² The UK ownership structure was not as dispersed as the US at that time. In fact, in the 1920s, after the US shareholding structure had completed its evolution, UK companies were still highly family-oriented, and remained so until the

²⁸⁹ Ibid 83,84 and Mark J Roe, 'Political and legal restraints on ownership and control of public companies' (1990) 27 *Journal of Financial Economics* 7-41. Roe explained the influence of political resistance on trusting corporate managers and how financial institutions could be trusted and concluded the US "legal system limited control by financial institutions ... (through) prohibition of stock ownership, fragmentation of financial institutions and fragmentation of institutional portfolios. "

²⁹⁰ Brian R. Cheffins, 'Mergers and the Evolution of Patterns of Corporate Ownership and Control: The British Experience' (2004) 46 *Business History* 256, 284.

²⁹¹ Julian R Franks, Colin Mayer and Stefano Rossi, 'The Origination and Evolution of Ownership and Control ' (2003) CEPR Discussion Paper No. 3822 24.

²⁹² Brian R. Cheffins, 'Mergers and the Evolution of Patterns of Corporate Ownership and Control: The British Experience' (2004) 46 *Business History* 256, 284.

late 1950s.²⁹³ Research showed that during the 1950s, family board members still had a considerable influence in corporate governance in many key business enterprises,²⁹⁴ and data also show that family representation on the boards of companies was high.²⁹⁵ However, during the 1950s and 1960s, there was a remarkable “decline [in] family power in British industry”²⁹⁶ which accelerated the pace of ownership change in the UK. After that, the UK market developed to be similar to the US, with ownership separated from control. This ownership change improved corporate governance in the UK (and the US), and made the capital market more effective. Furthermore, merger waves helped the expansion of companies from their hometowns to the national level, issuing shares to a wide range of investors in the process.²⁹⁷

The UK capital market is said to be “deep and efficient” and, according to the UK’s listing rules, “actively discourage[s] block-holdings of above 30%” which has encouraged “the strong dominance of the widely-held ownership group”.²⁹⁸

²⁹³ David J. Jeremy, *A Business History of Britain* (OUP 1998) 199 and 205-209.

²⁹⁴ Andrea Coli and Mary B. Rose, ‘Families and Firms: The Culture and Evolution of Family Firms in Britain and Italy in the Nineteenth and Twentieth Centuries’ (1999) 47 *Scandinavian Economic History Review* 31,37.

²⁹⁵ Julian R Franks, Colin Mayer and Stefano Rossi, ‘The Origination and Evolution of Ownership and Control ’ (2003) CEPR Discussion Paper No. 3822 12.

²⁹⁶ Brian R. Cheffins, ‘Mergers and the Evolution of Patterns of Corporate Ownership and Control: The British Experience’ (2004) 46 *Business History* 256, 284.

²⁹⁷ Julian R Franks, Colin Mayer and Stefano Rossi, ‘The Origination and Evolution of Ownership and Control ’ (2003) CEPR Discussion Paper No. 3822 22.

²⁹⁸ Jeremy Grant and Thomas Kirchmaier, ‘Corporate Ownership Structure and Performance in Europe’ (2005) 2 *European Management Review* 231, 231.

b. Yigu Duda (highly concentrated Shareholding Structures in China)

In China, however, things are more complicated due to the controversial nature of China's shareholding structure. Most shareholding structures are either highly concentrated or highly dispersed, and most major shareholders are institutional investors. In many cases, the controlling shareholder is the state. Data show that, up to the end of 2008, only a small number of companies listed in China were controlled by foreign investors, and about 35 per cent of listed companies were controlled by private investors. The rest were controlled directly or indirectly (through different entities) by the state.²⁹⁹ Moreover, at that time, hostile takeovers seemed impossible in that market because most state-owned shares are non-tradable.

In the 1990s, the purpose of listing Chinese SOEs on the stock market was to improve SOEs' corporate governance and raising capital by offering shares to the public and minority shareholders who might put pressure on the board of directors and give the SOEs the impetus to resolve long-standing financing problems.³⁰⁰

From 2005, China Securities Regulatory Commission (CSRC) has led a 'share segregation reform' to convert non-tradable shares in China's market into publicly-tradable shares. This reform is aiming at diversifying the shareholding

²⁹⁹ Menfu Huang, *Zhongguo Minying Jingji Fazhan Baogao [Report on the Development of the Private Economy in China]* (Social Science Literature Publishing company 2009) 15.

³⁰⁰ China Stock Market Handbook Editorial Board, *China Stock Market Handbook* (Javvin Press 2008) 3.

structure for China's listed companies.³⁰¹ The reform has successfully prevented the government from being both the main sponsor of SOEs and the manager at the same time, in order to liberate the executive board of listed companies. However, as in a shareholder-friendly market, the state still has certain powers over major decisions, such as the sale of the companies. According to the data of both CRSC and State-owned Assets Supervision and Administration Commission of the State Council (SASAC),³⁰² there were 953 listed companies out of total 2,387³⁰³ in the A share market in China which involved the state as a stakeholder, with a total value of 13.71 trillion RMB investment.³⁰⁴ Even if the state claims that they are freeing the market to make it one without government interference (the SASAC has promised to allow listed companies to be managed by the executives, and not the authority itself), its influence over listed companies is still strong, with a large amount of shares of controlled by the state authority indirectly. It could be argued that the performance of SOEs "was not significantly different than that of private-sector firms in the same industry".³⁰⁵ However, some scholars disagree, and have argued that this research

³⁰¹ Fang Liu, 'Takeover Defenses Under PRC Law(Part I)' (2006) June China Law & Practice <<http://www.chinalawandpractice.com/Article/1692122/Channel/9939/Takeover-Defenses-Under-PRC-Law-Part-I.html>> accessed 20 April 2013.

³⁰² It is the official authority of the state to manage the investment of the state in China.

³⁰³ CSRC, *Statistics of December 2012* (CSRC 22 Jan 2013).

³⁰⁴ Tianliang Bai, 'Renmin Ribao: Guoyou Zichan Jianguan Tizhi Gaige 10 Nian Gaige Cuisheng Xin Guoqi [People's Daily: 10 Years of the Oversight System for SOE Assets Reform Which Pushed the Emergence of New SOE]' (21 May 2013) <<http://www.sasac.gov.cn/n1180/n1271/n20515/n2697175/15333298.html>> accessed 22 May 2013.

³⁰⁵ Stacy Kole and J. Harold Mulherin, 'The government As a Shareholder: A Case From the United States' (1997) 30 J L & Econ 1,22.

and its conclusion had limitations.³⁰⁶ Additionally, SOEs may never face the problem of “hard budget constraints”,³⁰⁷ as the state has taxation powers and may use them to rescue an SOE from funding difficulties. Moreover, it is also suggested that the SOEs lack discipline in the capital market, which made them “less motivated and efficient than private companies”.³⁰⁸

2) Differences between China’s market and the UK and US markets

To understand the takeover-related issues in a specific market, it is necessary to discuss what kind of market it is, whether mergers and acquisitions happen frequently and then one can make a judgement as to what kind of legislation will be most suited to that market. As the UK and the US have developed markets, it will be helpful to discuss these markets’ developmental process and their features, and then compare them with China’s market.

The US and the UK markets are the two foremost international markets in the world. The former is the more ‘popular’, with most of the Fortune 500 companies listed on it, and is more familiar to Chinese companies because some Chinese companies are now listed there. The latter has evolved gradually, “from a market organized to trade in

³⁰⁶ Guanghua Yu, ‘The Problem with the Transplantation of Western Law in China’
<<http://ssrn.com/abstract=1535683> > accessed 22 April 2013.

³⁰⁷ Budget constraints are a form of economic coercion: proceeds from sales and cost of input are a question of life and death for firms. This definition was established by Janos Kornai, and the introduction of this concept can be found in Janos Kornai, “Hard” and “Soft” Budget Constraint’ (1980) 25 *Acta Oeconomica* 231,245.

³⁰⁸ Guanghua Yu, ‘The Problem with the Transplantation of Western Law in China’
<<http://ssrn.com/abstract=1535683> > accessed 22 April 2013 18.

government securities to a market spanning the globe and the industrial spectrum”.³⁰⁹

Scholars have found that the “correlation between the UK and the US markets [has increased] since the 1950s, and in the years since 2010 has been stronger than ever”.³¹⁰

a. Brief introduction to the development of UK and US markets

The New York Stock Exchange (NYSE) dates from 1792 and became the major US securities market within a few decades of its founding.³¹¹ It is the largest securities market in the world.³¹² It is said that the reason the NYSE is the dominant market is a combination of both Dutch and British “financial innovation and entrepreneurship”,³¹³ and the NYSE playing to its strengths over time.

The US market has experienced some disruption during these 400 years, particularly in 1929. At the beginning of 1920s, the US stock market experienced a huge increase

³⁰⁹ Lance E. Davis and Robert E. Gallman, *Evolving Financial Markets and International Capital Flows* (Cambridge University Press 2001) 182.

³¹⁰ Stephen Eckett, *UK Stock Market Almanac (2013)* (Harriman House Limited 2012) 6.

³¹¹ Richard Sylla, ‘The Origins of the New York Stock Exchange’ in William N. Goetzmann and K. Geert Rouwenhorst (eds), *The Origins of Value : the Financial Innovations that Created Modern Capital Markets* (OUP 2005) 300.

³¹² Ibid 312.

³¹³ Ibid 312. According to Sylla’s research, the Dutch and English financial revolutions energized their economies, provided ways of managing and reducing risks, and mobilized capital so that it could be allocated with greater efficiency. In addition, “ they create[d] a lot of useful economic information-securities prices, interest rates and bond yields.” They provided good samples for the US to reform its market after the Federalist financial revolution.

in its total volume and “the public entered the market in greater and greater numbers”.³¹⁴ It was said to be a New Era in America at that time, but there was the storm shortly after the boom, when on the 23rd of October, 1929, there was an incredible rapidly fall in the stock market, bringing this New Era to its end.³¹⁵ This crisis provided a lesson to investors that an immature market without regulation or supervision can threaten society.³¹⁶

A recent change in the NYSE came in 2005 when the NYSE became an advanced “hybrid market”,³¹⁷ which “combines cutting-edge technology with human judgment and accountability to create strong, transparent financial markets”.³¹⁸ This change increased competition within the companies listed on the NYSE and led it to be a more efficient market with better services.³¹⁹ One thing is certain after its centuries of

³¹⁴ Richard J. Teweles and Edward S. Bradley, *The Stock Market* (7th edn, John Wiley & Sons Inc 1998) 122.

³¹⁵ Ibid 122.

³¹⁶ Bin Qi, ‘Ziben Shichang yu Zhongguo Jingji Shehui Fazhan [Capital Market and the Development of China's Economic Society]’ (2012) 26(9) *China Business and Market* 13,19.

³¹⁷ David S. Kidwell and others, *Financial Institutions, Markets, and Money* (John Wiley & Sons, Inc, 2008) 272.

³¹⁸ NYSE Euronext, ‘Markets’ <<http://usequities.nyx.com/markets>> accessed 11 May 2013

According to the information provided on the official website, “the US Options market is one of the largest, most liquid and fastest growing derivatives markets in the world...(The US options market) can provide twelve US Options exchanges” using advanced technologies, for example, “BATS Options offers a price-time priority trading model and operates a fully electronic trading platform”, “NYSE Arca Options offers a price-time priority trading model and operates a hybrid trading platform that combines a state-of-the-art electronic trading system, together with a highly effective open-outcry trading floor in San Francisco, CA” and “NASDAQ OMX PHLX offers a traditional allocation model and operates a hybrid trading platform, with both an electronic system and open-outcry trading floor”.

³¹⁹ David S. Kidwell and others, *Financial Institutions, Markets, and Money* (John Wiley & Sons, Inc, 2008) 273.

development: the US market is very attractive to investors because it could be said to be the most mature market in the world.

In the UK, there were once much smaller provincial stock exchanges,³²⁰ but the major stock market is the London Stock Exchange (LSE). The LSE merged lots of stock exchanges to incorporate its branches, such as the Glasgow Stock Exchange, and dates back to the 17th century.³²¹ Over about 300 years of development, the London Stock Exchange has “expanded in geographic breadth from national to international and in industrial scope from governments to various industrial securities”.³²² Now it has about 3,000 companies from more than 70 countries trading on it,³²³ making it one of the most international markets in the world. The types of shares listed on the LSE are various, but the most important one is the ordinary share.³²⁴ It is generally believed that most of the shares issued before 1885 were

³²⁰ Lance E. Davis and Robert E. Gallman, *Evolving Financial Markets and International Capital Flows* (Cambridge University Press 2001) 166.

³²¹ London Stock Exchange official website, ‘Our History’
<<http://www.londonstockexchange.com/about-the-exchange/company-overview/our-history/our-history.htm>> accessed 04 May 2013.

³²² Lance E. Davis and Robert E. Gallman, *Evolving Financial Markets and International Capital Flows* (Cambridge University Press 2001) 182.

³²³ LSE official website, ‘Company Overview’
<http://www.londonstockexchange.com/about-the-exchange/company-overview/company-overview.htm>
accessed 04 May 2013.

³²⁴ “Ordinary shares are the most common form of share in the UK. An ordinary share gives the right to its owner to share in the profits of the company (dividends) and to vote at general meetings of the company.” See LSE, ‘Security Types’
<<http://www.londonstockexchange.com/traders-and-brokers/security-types/security-types.htm>>
accessed 04 May 2013.

ordinary shares³²⁵; shortly after that, 12 per cent of listed companies shares were preference shares,³²⁶ which were mostly issued by “overseas railroad and finance companies”.³²⁷ By the end of the 1890s, the commercial banks and other financial institutions became more and more competitive in the market than the large merchant banks, which has previously played a key role in the LSE,³²⁸ making the market livelier.

The LSE has undergone various revolutions over the course of its development, including some very significant recent change. Since the beginning of the 1970s, the internationalization of finance had changed the world economy dramatically. The US had already started to prepare their market for a more international outlook at that time,³²⁹ and in the 1980s, the volume of the Tokyo Stock Exchange was big enough to challenge the leadership of the NYSE and the LSE.³³⁰ Thus it is reasonable to think that the UK would have lost its market share had it not made some changes to keep up with other markets. After the Big Bang of October 1986, the LSE came to be dominated by non-member firms, which enabled the exchange to function as a mutual

³²⁵ Lance E. Davis and Robert E. Gallman, *Evolving Financial Markets and International Capital Flows* (Cambridge University Press 2001) 165.

³²⁶ Also known as “preferred stock” - “Owners of preferred stock ...usually receive preferential treatment over common stockholders when it comes to receiving dividends or cash payoffs in bankruptcy.” See David S. Kidwell and others, *Financial Institutions, Markets, and Money* (John Wiley & Sons, Inc, 2008) 261.

³²⁷ Lance E. Davis and Robert E. Gallman, *Evolving Financial Markets and International Capital Flows* (Cambridge University Press 2001) 165.

³²⁸ Ibid 168.

³²⁹ Ibid 53.

³³⁰ Lance E. Davis and Robert E. Gallman, *Evolving Financial Markets and International Capital Flows* (Cambridge University Press 2001) 896.

organization for all members; it also reformed trading technology to make all transactions more promptly. The removal of price fixing in trading commissions was another outcome of the Big Bang.³³¹ The Big Bang not only changed the LSE; it also made things different elsewhere. UK financial institutions' structures changed.³³² The financing atmosphere became more competitive than before. Secondly, after the Financial Services Act 1986, investor protection was increased. Additionally, the development of risk products threatened the LSE's trading during these years.³³³

The Big Bang raised awareness of the effectiveness of investor protection, and during the revolution that followed, the government deregulated the financial markets and increased its attention on the protection of investors.³³⁴ Today, the London capital market is extremely competitive in the world economy, just like the US.

b. A brief introduction to China's market

China's market is young compared with the US and the UK markets, but its development has been incredibly rapid. The emergence of the household contract responsibility system (HCRS)³³⁵ directed the original shape of the shareholding

³³¹ Peter Morriss and Jeffrey K. Pinto, *The Wiley Guide to Project, Program, and Portfolio Management* (John Wiley & Sons 2010) 279.

³³² David Blake, *Financial Market Analysis* (2nd edn, John Wiley & Sons, LTD 2000) 52.

³³³ Ibid 52-53.

³³⁴ Ibid 55.

³³⁵ HCRS was carried out in 1978 in China's rural areas, and it involved leasing collectively cultivated land by contract to individual peasant households for operation. It greatly motivated peasants' enthusiasm for production and the potential of the agricultural sector was exploited to a much higher degree. See Rongbo Zhu and Yan Ma, *Information Engineering and Applications: International Conference on Information Engineering and Applications* (Springer Science & Business Media 2011)

economy that provided the foundation of building a capital market in China.³³⁶ In 1981, China's financial market was created to meet the rapidly growing economy by establishing a bond market.³³⁷ Shortly after that, the government recognised that the bond market could not meet the liquidity needs of the state-owned enterprises,³³⁸ and both private and state-owned enterprises were left facing serious financial difficulties. As a result, the government established two nationwide stock exchanges, which made remarkable contributions to the economic development of China and acted as the key financing markets for China from that point onwards. These were the Shanghai Stock Exchange (1990) and Shenzhen Stock Exchange (1991).³³⁹ After over 20 years' progress, China's stock market experienced a rapid development. The number of listed companies on China's two stock exchanges boomed from 53 in 1992 to 2,342 in 2011,³⁴⁰ increasing to a total turnover of 42,164.97 billion Yuan.³⁴¹

Of great relevance to introduce China's market is the typology of shares that are listed. China's shares are divided into two classes, "depending on the [eligibility of] buyers

469 and Ma Ying and Hans-Michael Trautwein, *Thoughts on Economic Development in China* (Routledge 2013) 220.

³³⁶ China Securities Regulatory Commission, *China Capital Markets Development Report* (China Financial Publishing House, 2008) 28.

³³⁷ Hong Wu, *Zhongguo Zhengquan Shichang de Falv Tiaokong [Legal Adjustment of the Development of China's Securities Market]* (Law Press 2001) 2.

³³⁸ Wei Zhang & Li Chu, 'Introduction' in Wei Zhang (ed), *Zhongguo Zhaiwu Wenti Yanjiu [Research on the Question of China's Debts]* (China Financial Publishing House 1995) 42.

³³⁹ Hong Wu, *Zhongguo Zhengquan Shichang de Falv Tiaokong [Legal Adjustment of the Development of China's Securities Market]* (Law Press 2001) 8.

³⁴⁰ CSRC, *Summary for Securities Market* (2012).

³⁴¹ Ibid.

and the currency in which the shares are denominated”.³⁴² One class represents “A Shares” (or “A Gu”), which are shares listed on the Shanghai or Shenzhen stock exchanges and denominated in the Chinese currency - the RMB. These are only accessible to domestic investors.³⁴³ Usually the market players in A Share market are domestic investors – such as individual person and domestic institutional investors etc., but since China’s economy develops in recent years, it does allow certain foreign investors to invest in China’s domestic A Share market such as QFII and Renminbi Qualified Foreign Institutional Investor (RQFII).³⁴⁴ However, the QFII and RQFII should invest in China’s A Share market within certain quota set by Chinese government.³⁴⁵ The other class of shares, “B shares”, are listed on both the Shanghai and Shenzhen stock exchanges carrying “a face value denominated in RMB” but are subscribed and traded in US Dollars. These are open to all investors, both in China and abroad.³⁴⁶ Only 0.05 per cent (108 out of 2,342) of all the companies listed on China’s stock exchange issue B shares, according to CSRC data.³⁴⁷ This thesis

³⁴² Hui Huang, ‘China’s Takeover Law: A Comparative Analysis and Proposals for Reform’ (2005) 30 Delaware Journal of Corporate Law 145, 149.

³⁴³ China Stock Market Handbook Editorial Board, *China Stock Market Handbook* (Javvin Press 2008) 37.

³⁴⁴ RQFII is launched in December 2011 which allowed a small number of Chinese financial firms to establish RMB denominated funds in Hongkong for investment in the mainland. See Regulation on Domestic Securities Investment by Qualified Foreign Institutional Investor 2013.

³⁴⁵ Ibid a.3.

³⁴⁶ Hui Huang, ‘China’s Takeover Law: A Comparative Analysis and Proposals for Reform’ (2005) 30 Delaware Journal of Corporate Law 145, 149.

³⁴⁷ CSRC, Summary for Securities Market (2012) available at CSRC official website <http://www.csrc.gov.cn/pub/newsite/xxfw/cbwxxz/tjnj/zqqhtjnj/2012/main/nj2011/1-1.htm> accessed 1 May 2013.

therefore mainly focuses on the buying and selling of “A shares” in China’s listed companies.

c. Whether the market in China is developed and mature

Since China entered the World Trade Organisation in 2006, China’s coastal cities and provinces have created more wealth “than at possibly any time in the world history except the post-war US”.³⁴⁸ However, China’s stock market and the securities industry did not experience rapid development during that time. China’s economy was lacking in private property and was “dominated in all important aspects by agencies of the government” so that the stock market could not adapt to the economy.³⁴⁹

According to Wei’s research, share prices could not reflect the economic performance of listed companies with the existence of non-tradable shares. Changes in stock prices in China’s market are divorced from the actual business activities of listed companies, and share prices can be greatly influenced by major shareholders when there are a large percentage of non-tradable shares. This is closely related to the proportion of the stock’s price-earnings ratio of non-tradable shares: the greater the proportion of

³⁴⁸ Carl E. Walter & Fraser J. Howie, *Privatizing China: Inside China’s Stock Markets* (2nd edn edn, John Wiley & Sons Singapore 2011) “Preface”.

³⁴⁹ Ibid “Preface”.

non-tradable shares, the larger the price-earnings ratio will be, resulting in a decline of the value of investment in the stock market.³⁵⁰

As a result, the state has tried to reform non-tradable shares since 2005 to solve the problems³⁵¹ and it was “basically finished” in this task by the end of 2007³⁵². The reforms successfully made the state sell its non-tradable shares over a period of time, with all shares tradable in the market by the end.³⁵³ According to the most recent monthly report from China Securities Depository and Clearing Corporation (CSDC), 91.82 per cent of restricted shares successfully became tradable until March 2016 and there are only extremely small amount of non-tradable shares in China’s market – less than 1/10,000 of the total shares of China’s market.³⁵⁴ However, there is still no clear evidence that the non-tradable share reform has prevented the government from dominating listed companies. Indeed, the state remains, to some extent, the major shareholder in many listed companies in China. However, the reform resolved problems with the divergence in share prices among state owned shares, legal person shares and tradable shares, unifying the share pricing mechanism. Moreover, these

³⁵⁰ Junfeng Wei, ‘Effect of Non-tradable Share Stock on Stock Market and Listed Company’ (2004) 3 China Economic Quarterly 475, 485.

³⁵¹ Tao Zhang, ‘Empirical Study on the Effectiveness of Split-share Structure Reform on China’s Stock Market’ (2008) 3 Jianghai Academic Journal 75, 75.

³⁵² China Securities Regulatory Commission, *China Capital Markets Development Report* (China Financial Publishing House, 2008) 52.

³⁵³ Hui Huang, ‘China’s Takeover Law: A Comparative Analysis and Proposals for Reform’ (2005) 30 Delaware Journal of Corporate Law 145, 158.

³⁵⁴ CSDC, CSDC Monthly Report March 2016, available at http://www.chinaclear.cn/zdjs/editor_file/20160415172142282.pdf accessed 1 May 2016.

reforms changed China's stock market from being a weak to an efficient market.³⁵⁵ At the same time, the government improved the supervision mechanisms for listed companies to increase the effectiveness of supervisory actions.³⁵⁶ With an improved supervision system and less state intervention the market could be expected to play as a free and effective market for the investors. Data show that from 2006, on the basis of this more defensible legal framework, China's capital market expanded rapidly, and transactions in the market were more frequent. By the end of 2007, the total market value of 1,550 listed companies stood at 327,000 billion RMB (roughly 32,700 billion GBP). This was equivalent to 132.6% of China's Gross National Product (GNP) at that time and made China the biggest emerging market in the world.³⁵⁷

That said, according to one report by the CSRC, China's market remains an "emerging and transitional" market and is still evolving.³⁵⁸

3) What are the strengths and weaknesses of China's market compared with the UK and the US?

Both the NYSE and the LSE experienced some revolutions in developing their markets, and the long-term effects of these revolutions seem to have been similar:

³⁵⁵ Tao Zhang, 'Empirical Study on the Effectiveness of Split-share Structure Reform on China's Stock Market' (2008) 3 Jianghai Academic Journal 75, 80.

³⁵⁶ China Securities Regulatory Commission, *China Capital Markets Development Report* (China Financial Publishing House, 2008) 56.

³⁵⁷ Ibid 77.

³⁵⁸ Ibid 2.

they all resulted in a “reduction in commissions and spreads on large trades and an increase in the volume of activity”.³⁵⁹ Both countries have a market-oriented corporate governance system and their markets seem to be freer than China’s. However, it is hard to say that a market with highly dispersed shareholding structure is better than one with a concentrated shareholding structure.³⁶⁰ Both markets have their own strengths. Research shows that the with dispersed shareholding structure shareholders lack the incentives to monitor the managers and to exercise their voting rights, but with concentrated shareholding structure “large shareholders are both willing and able to monitor the managers”.³⁶¹

Generally, shareholders have the power to decide whether to remove or keep directors in the UK; under China’s law, while a shareholders’ meeting is supposedly the highest authority within a company, it does not play the ideal function as it was designed to do³⁶² especially for minority shareholders. In China, shareholders are guaranteed the right to elect directors according to Company Law,³⁶³ but there are no specific or detailed regulations on how shareholders may elect or recall the directors.

³⁵⁹ David Blake, *Financial Market Analysis* (2nd edn, John Wiley & Sons, LTD 2000) 56

³⁶⁰ Guanghua Yu, ‘Does One Size Fit All? Transplanting English Takeover Law into China’ in Lehman (ed), *Corporate Governance: Does Any Size Fit?* Advances in Public Interest Accounting, vol 11 (Elsevier Ltd 2005) 47

³⁶¹ Sherman and Sterling, ISS and ECGI, *Report on the Proportionality Principle in the European Union* (2006)

<http://ec.europa.eu/internal_market/company/docs/shareholders/study/final_report_en.pdf> accessed 1 May 2016 at page 10.

³⁶² Colin Law and Patricia Wong, ‘Corporate Governance: A Comparative Analysis Between the UK and China’ (2005) 16 ICCLR 350, 356.

³⁶³ Company Law of the People’s Republic of China (2005 revision) a.37.

In fact, in China, most directors are nominated by major shareholders because they have more voting rights, whereas minority shareholders can only suggest director candidates but cannot decide who will actually become directors.³⁶⁴ There are many SOEs in China and in which the directors are chosen by the government.³⁶⁵ Moreover, it is claimed that boards of directors control shareholder meetings and make it even more difficult for shareholders to supervise the board's performance.³⁶⁶ That may not be a consequence of the concentrated ownership structure in China, however. In a market with a dispersed shareholding structure, the way to motivate the board of directors to maximize the shareholders' interest is to give them higher remuneration.³⁶⁷ There are also fiduciary duties for directors established in relevant company law in the UK and the US to ensure that directors operate in a manner concordant with a 'good faith' approach.³⁶⁸ However, whether the directors actually manage their company in good faith, with the motivation of a high salary, is questionable. Indeed, it could be expected that directors will make some, or more, decisions in their own interests. For example, in the US, the directors have the power to decide whether to accept an offer or not. Once a hostile takeover bid is announced,

³⁶⁴ Juan Jiang, 'On the Director Candidate's Nomination Right for Shareholder' (2011) 16 Journal of Hunan University of Technology Social Science Edition 48, 52.

³⁶⁵ Jigen Zhong, 'Gongsi You Shui Zhudao, Gudong, Jingli Haishi Dongshi? [Who Direct the Company, Shareholders, Managers or Directors?]' (2013) April China New Era 88, 89.

³⁶⁶ Colin Law and Patricia Wong, 'Corporate Governance: A Comparative Analysis Between the UK and China' (2005) 16 ICCLR 350, 356.

³⁶⁷ Guanghua Yu, 'Does One Size Fit All? Transplanting English Takeover Law into China' in Lehman (ed), *Corporate Governance: Does Any Size Fit? Advances in Public Interest Accounting*, vol 11 (Elsevier Ltd 2005) 47.

³⁶⁸ The duties all directors should have could be found in Companies Act 2006 Pt10 Ch2 and Delaware General Corporation Law Ch1.

the target company's director may make a de facto decision for the company as it is possible that the directors will refuse the offer in order to prevent being moved from the target company themselves.

In a market with a concentrated ownership structure like China, if the majority shareholders have sufficient ability to monitor the company, with the incentive of a greater share premium, the performance of listed companies should not be worse than companies operating in a dispersed ownership market. Admittedly, the US and UK markets are more mature than China's, with a longer history and more experience. That said, the incredible speed of China's market development cannot be denied. Problems nonetheless exist in China's market, not only in terms of the highly concentrated shareholding structure, but also in the value of the listed companies. As China's major shareholder in the market is the state, the market is not able to divest itself from state interference completely. The existence of this special shareholder should not be seen as a straightforward defect in China's market or as an obstacle to transplanting western regulations to develop China's market, however. If the State can avoid the abuse of its power in business transactions, it could operate as a professional shareholder, alongside the well-educated members of the SASAC. This 'special' shareholder could also act as an institutional shareholder in deciding key issues regarding listed companies.

3. Different legal framework

As an emerging market, China is still on the way to establishing a well-functioning stock market. An efficient capital market requires not only a sound transaction system, but also regulations to “deal with the abuse and ... credibility of the threat of using the law to deal with abuse”.³⁶⁹ Thus, it is necessary to consider the legal framework of each country in order to establish what kind of legislation each country has that is aimed at ensuring market efficiency and the protection of investors.

1) A brief introduction to the regulatory framework in the UK and US

The UK and the US, as two advanced western economies, have legal frameworks different from China, and from one another. It is therefore essential to consider the differences between these countries before discussing how to transplant a western takeover regulatory system to China.

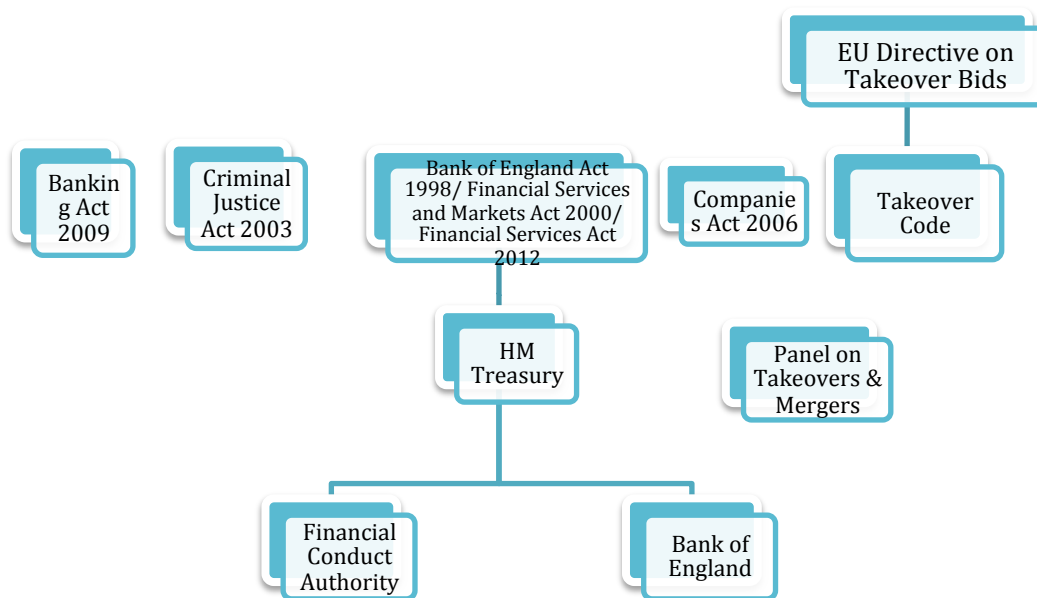
The UK’s legal framework is basically enshrined within common law, statutes and other regulations. Common law principles have developed through case law while standards for the conduct of takeover have been developed by the industry itself.³⁷⁰ There are also some regulations that may influence UK legislation regarding takeovers, such as the EU Directive, as mentioned in the previous chapter. Additionally, the regulation of directors’ duties is an important element of takeover

³⁶⁹ Guanghua Yu, ‘The Problem with the Transplantation of Western Law in China’ <<http://ssrn.com/abstract=1535683>> accessed 22 April 2013 18.

³⁷⁰ Stefan Fafinski and Emily Finch, *English Legal System* (3rd edn, 2010) 3.

regulation, the principles of which are included in the Companies Act 2006. As part of corporate governance regulations, there are also some reports³⁷¹ that have influenced the legal framework as well.³⁷²

In the UK, the stock market is regulated by a system of regulatory bodies. This is illustrated in the figure below:



The London Stock Exchange (LSE) can be seen as a financial service institution, regulated by the Financial Conduct Authority (FCA), with the FCA's control

³⁷¹ "Following a number of financial scandals in the late 1980s and early 1990s, the UK responded by imposing a set of self-governance regulations with the support of the Government, the LSE and other relevant regulatory and independent bodies." And these reports issued during that time provided the foundation of UK's corporate governance reform. See Colin Law and Patricia Wong, 'Corporate Governance: A Comparative Analysis Between the UK and China' (2005) 16 ICCLR 350, 351.

³⁷² Ibid 351.

responsibility delegated by the HM Treasury.³⁷³ Resultantly, most transaction procedures that occur on the LSE are regulated by FCA.³⁷⁴ The Companies Act also regulates the responsibilities of the directors and provides some general guidelines,³⁷⁵ while the Criminal Justice Act 2003 serves to “prohibit the use of confidential inside information”.³⁷⁶ These are the primary pieces of legislation that regulate the behaviour of end-users of the UK’s financial system – such as the directors of listed companies. The Banking Act 2009 regulates the banking system, and aims at preventing “unauthorized business and illegal deposit taking”.³⁷⁷ Additionally, a regulatory body pertinent to this thesis is the Panel on Takeover & Mergers (the Panel), which is a body established in 1968 that operates according to the Takeover Code (‘the Code’). The panel used to be a non-statutory body³⁷⁸ that finally gained statutory functions under Chapter 1 of Part 28 of the Companies Act 2006.³⁷⁹ As stated on the Panel’s official website, its “main functions are to issue and administer the Takeovers Code and to supervise and regulate takeovers and other matters to which the Code applies. Its central objective is to ensure fair treatment for all shareholders in takeover bids”. The Code is not concerned with matters regarding the corporation and its shareholders, such as the financial or commercial advantages or

³⁷³ David Blake, *Financial Market Analysis* (2nd edn, John Wiley & Sons, LTD 2000) 45.

³⁷⁴ The controlling power delegated to HM Treasury exists due to the Bank of England Act 2009, the Financial Services and Markets Act 2000, and the Financial Services Act 2012.

³⁷⁵ David Blake, *Financial Market Analysis* (2nd edn, John Wiley & Sons, LTD 2000) 50.

³⁷⁶ *Ibid* 51.

³⁷⁷ *Ibid* 48.

³⁷⁸ David Blake, *Financial Market Analysis* (2nd edn, John Wiley & Sons, LTD 2000) 45.

³⁷⁹ Companies Act 2006 part 28 ch.1.

disadvantages of a takeover, however. Additionally, public interest questions, such as competition issues are “the responsibility of other regulatory bodies, such as the Competition & Markets Authority and the European Commission”.³⁸⁰ Presently, the UK courts are reluctant to intervene in takeovers and leave the Panel to act as “the judge and the jury in takeover matters”.³⁸¹

The US regulatory system is a little complicated. The US is a common law country like the UK, but their systems are not totally the same. The US Constitution is the “supreme Law of the Land”, under which federal and state legislation must exist.³⁸² Legislation thus exists in a hierarchy in the US; takeover legislation is no exception.

There are three major US markets (the NYSE, American Stock Exchange, and the NASDAQ³⁸³) and some small regional markets. These are regulated by the government and industry simultaneously.³⁸⁴

The current regulatory system is represented in the figure below:

³⁸⁰ The Takeover Panel, ‘About the Panel’

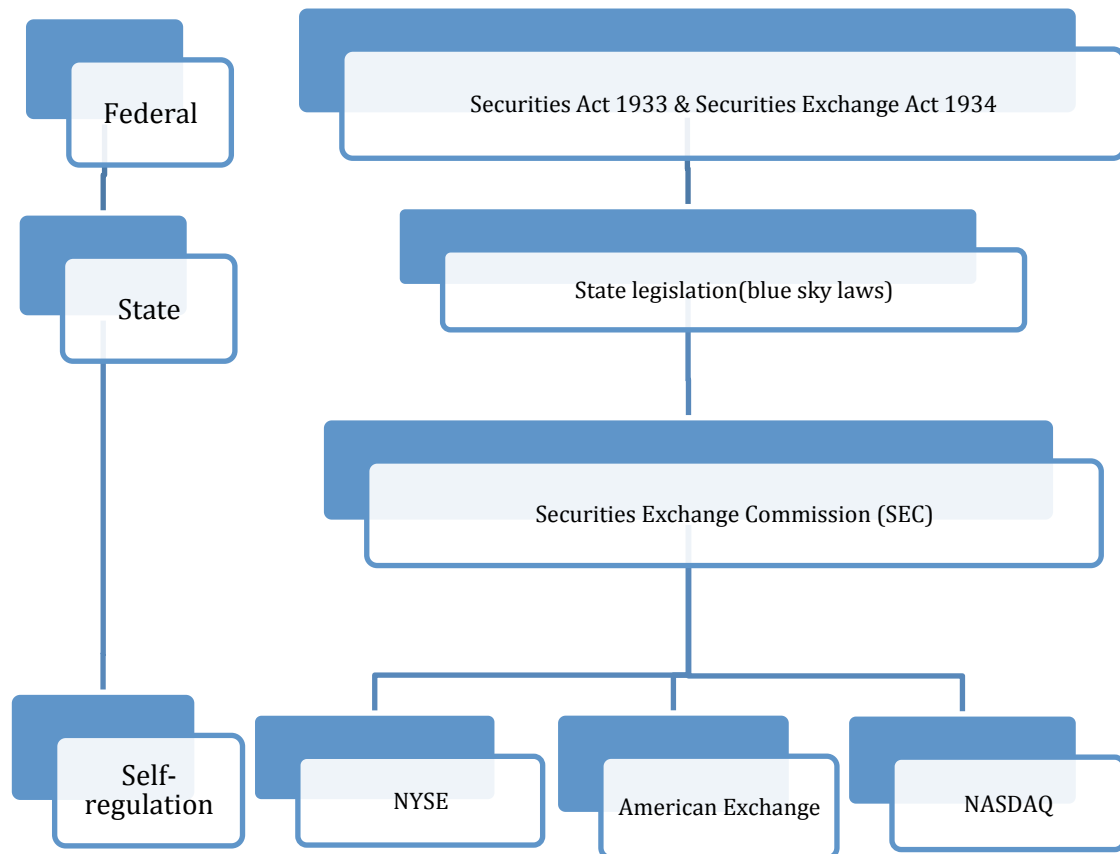
<<http://www.thetakeoverpanel.org.uk/structure/about-the-panel>> accessed 04 May 2013.

³⁸¹ Jonathan Mukwiri, ‘The Myth of Tactical Litigation in UK Takeovers’ (2008) 8 *Journal of Corporate Law Studies* 373, 388.

³⁸² E. Allan Farnsworth, *An Introduction to the Legal System of the United States* (Oceana Publications, Inc 1963) 59-61.

³⁸³ National Association of Securities Dealers Automated Quotation, which deals with median quotes for 2,500 over-the-counter securities. See NASDAQ’s official website <<http://www.nasdaqomx.com/aboutus/whatisnasdaq/>> accessed 11 May 2013.

³⁸⁴ William J Baumol and Alan S Blinder, *Economics: Principles & Policy* (12th edn, Cengage Learning, Inc 2011) 183.



The US regulatory system has three levels: the first is the federal government, followed by state government, and then the industry itself.³⁸⁵ There are two major pieces of pertinent legislation in the US: one is the Securities Act 1933; the other is the Securities Exchange Act 1934. The latter created a federal agency to oversee the US market, forming the Securities and Exchange Commission (SEC).³⁸⁶ Each state also has legislation to regulate securities activities and prevent dishonest securities

³⁸⁵ Richard J. Teweles and Edward S. Bradley, *The Stock Market* (7th edn, John Wiley & Sons Inc 1998) 348.

³⁸⁶ *Ibid* 351.

salesmen from selling “building lots in a blue sky”,³⁸⁷ the states’ Securities Acts are therefore often called “blue sky laws”.³⁸⁸ Additionally, self-regulation plays an important role in the American system. The SEC only covers federal requirements and will become involved in cases that violated federal statutes, especially those “involving fraud, insider trading, takeover attempts, and the sale of unregistered securities.”³⁸⁹

As discussed in the last chapter, US takeover legislation is more “director-friendly” than UK legislation as directors’ professional knowledge is trusted over that of institutional investors’; the features of the US market must also be taken into account. Unlike the case in the UK, in the US, a large percentage of household shareholders can limit the ability of shareholders to control companies such that the directors may be the best individuals to wield power in terms of their responsibility to manage companies responsibly, for shareholders.

2) A brief introduction to current takeover-related regulation in China

³⁸⁷ Paul G. Mahoney, ‘The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses’ (2003) 46 *Journal of Law and Economics*, 229, 229.

³⁸⁸ See also in David S. Kidwell and others, *Financial Institutions, Markets, and Money* (John Wiley & Sons, Inc, 2008) 275

³⁸⁹ Richard J. Teweles and Edward S. Bradley, *The Stock Market* (7th edn, John Wiley & Sons Inc 1998) 364, 365

Before 1992, China's stock market was regulated by provincial regulatory bodies, and each body was relatively independent, operating under the directions of local governments.³⁹⁰

Now, there are some key national laws in China that regulate takeover activities, including the Securities Law, the Company Law and the Measures for the Administration of the Takeover of Listed Companies (Takeover Measures). The major supervisory authority is the China Securities Regulatory Commission. In addition, in 2005, the revision of China's *Company Law* perfected its mergers and acquisitions mechanism and corporate governance structure in order to coordinate with the development of China's market.³⁹¹ Furthermore, even though the companies' constitutions are not part of the takeovers legislation, they are important in regulating the relationship between the parties that may be involved in a transaction and often include some key provisions, such as those, which relate to the deployment of takeover defensive measures.³⁹²

As discussed previously, China's takeover law is more like the UK's, but the takeover-related legislation as a whole is a mix of US and UK regulations. On one hand, China's first national Securities law, the *Law of the People's Republic of China*

³⁹⁰ Hui Huang, 'China's Takeover Law: A Comparative Analysis and Proposals for Reform' (2005) 30 Delaware Journal of Corporate Law 145, 154.

³⁹¹ China Securities Regulatory Commission, *China Capital Markets Development Report* (China Financial Publishing House, 2008) 76.

³⁹² The idea of including company's constitution as a part of the legal framework could be found in Colin Law and Patricia Wong, 'Corporate Governance: A Comparative Analysis Between the UK and China' (2005) 16 ICCLR 350, 363.

on *Securities*, implemented China's "open door economic reform" policy,³⁹³ comprised of 12 chapters and 240 articles.³⁹⁴ These chapters consisted of the following: "(1) General Provisions, (2) Issuing of Securities, (3) Trading of Securities, (4) Acquisition of Listed Companies, (5) Stock Exchanges, (6) Securities Companies, (7) Securities Registrar and Clearance Institutions, (8) Securities Service Institutions, (9) Securities Industry Association, (10) Securities Regulatory Authority, (11) Legal Liability, and (12) Supplementary Provisions".³⁹⁵ When setting up these regulations, Chinese lawmakers referred to the US Securities Act and tried their best to adapt western securities legislation concepts to suit China's stock trading's needs.³⁹⁶ Indeed, the US Securities and Exchange Commission (SEC) and China's CSRC signed a Memorandum of Understanding regarding advice supplied to Beijing securities regulators in order to develop the Chinese financial market and, with the cooperation of the SEC, China's Securities Law became similar to the US', making it easy for interested western parties to relate to.³⁹⁷

China's stock market was established in 1990. The first law relating to takeovers in China was the *Tentative Regulations on the Administration of the Issuing and Trading*

³⁹³ Guanghua Yu and Minkang Gu, *Laws Affecting Business Transactions in the PRC* (Kluwer Law International 2002) 88.

³⁹⁴ Law of the People's Republic of China on Securities 2005.

³⁹⁵ Ibid.

³⁹⁶ Guanghua Yu and Minkang Gu, *Laws Affecting Business Transactions in the PRC* (Kluwer Law International 2002) 89.

³⁹⁷ Ibid 89.

of *Shares* in 1993,³⁹⁸ which introduced a mandatory bid rule similar to that of the UK.³⁹⁹ This rule was originally aiming at protecting minority shareholders, however, there are a few exemptions⁴⁰⁰ listed in the *Measures for the Administration of the Takeover of Listed Companies 2008* (Measures). To be specific, the procedures of all takeover activities are regulated by relevant laws and administrative regulations. The following principles are followed: (1) protection of shareholders,⁴⁰¹ (2) the contestability of takeovers,⁴⁰² and (3) effective supervision.⁴⁰³ According to Article 62 of the Measures, under certain circumstances below, the acquirer could apply for the CSRC to be exempt from making mandatory takeover offer:

“(1) the acquirer and the transferor can prove that the transfer has not altered the actual control of the listed company; (2) the listed company is confronted with serious financial difficulty and the acquirer has put forward a reorganization scheme to bail out the company that has been approved by the shareholders, and the acquirer promises not to transfer the shares held thereby within the subsequent 3 years; (3) the acquirer obtains the shares newly issued thereto to it

³⁹⁸ Wei Cai, ‘The Mandatory Bid Rule in China’ (2011) 12 *European Business Organization Law Review* 653, 653.

³⁹⁹ Article 48 of *Tentative Regulations on the Administration of the Issuing and Trading of Shares*, any legal person’s (other than a promoter’s) acquired 30 per cent of the total outstanding common shares of a listed company directly or indirectly within 45 working days should make a takeover bid for all of the remaining shares. *Tentative Regulations on the Administration of the Issuing and Trading of Shares* 1993, a.48.

⁴⁰⁰ *Measures for the Administration of the Takeover of Listed Companies 2008*, a.62.

⁴⁰¹ *Measures for the Administration of the Takeover of Listed Companies (2008 Revision)* a.1.

⁴⁰² Hui Huang, ‘China’s Takeover Law: A Comparative Analysis and Proposals for Reform’ (2005) 30 *Delaware Journal of Corporate Law* 145, 159.

⁴⁰³ *Measures for the Administration of the Takeover of Listed Companies (2008 Revision)* a.1.

by the listed company upon the approval of the non-interested shareholders of the listed company, which makes the shares held thereby by the acquirer over 30 per cent of the total, and the acquirer promises not to transfer the shares held thereby within the subsequent 3 years, and the general meeting of shareholders of the company agrees to the exemption for such a takeover bid; or (4) any other circumstance recognized by the CSRC for adapting to the developmental changes of the securities market or to the requirements for protecting the lawful rights and interests of the investors.”⁴⁰⁴

Meanwhile, if the acquirer failed to get exemption and extend a takeover offer, it shall make a cash offer.⁴⁰⁵ However, exemptions are claimed to lighten the acquirer’s financial burden but have failed to “offer protection to the minority shareholders in China, as expected”.⁴⁰⁶ Moreover, it is claimed that the mandatory bid rule only existed in name, and that exemptions existed to help state-controlled listed companies avoid the associated financial burdens.⁴⁰⁷

There are two major types of takeover procedure in China: the first is takeover by tender offer, and the second is takeover by private agreement.⁴⁰⁸ Before the completion of the reform of shareholding structure, most takeovers in China happened

⁴⁰⁴ Measures for the Administration of the Takeover of Listed Companies 2008 a.62.

⁴⁰⁵ Measures for the Administration of the Takeover of Listed Companies 2008 a.27.

⁴⁰⁶ Wei Cai, ‘The Mandatory Bid Rule in China’ (2011) 12 *European business Organization Law Review* 653, 668.

⁴⁰⁷ *Ibid* 672.

⁴⁰⁸ Hui Huang, ‘China’s Takeover Law: A Comparative Analysis and Proposals for Reform’ (2005) 30 *Delaware Journal of Corporate Law* 145, 157.

via private agreement because of China's large amount of non-tradable shares. According to China's Securities Law, "with respect [to] acquisition of the shares of listed companies which are held by the investment institutions authorized by the State, such acquisition shall be pursued in accordance with the provisions of the State and shall be subject to approval by the relevant department in charge."⁴⁰⁹ Thus, at that time, regulating takeover defensive measures seemed futile, because the decision-making power was mostly in the government's hands. However, according to Ruiz-Mallorquí and Santana-Martín's empirical research, conducted in Europe, the level of defensive tactics increase when principal shareholders are institutional in nature. This research also indicated that the adoption of takeover defences is facilitated by a concentrated ownership environment, because the principal shareholders could potentially do whatever was necessary to maintain control of the company.⁴¹⁰ Thus, it might not be entirely accurate to say that regulating takeover defence measures is a waste of time in China now.

A higher degree of diversification in a shareholder base would put the listed companies under the threat of hostile takeovers.⁴¹¹ For example, it is acknowledged that 20-25 per cent of shares is seen as a line for the largest shareholders to control the

⁴⁰⁹ Law of the People's Republic of China on Securities 2005, a. 101.

⁴¹⁰ M. Victoria Ruiz-Mallorquí and Domingo J. Santana-Martín, 'Ultimate Institutional Owner and Takeover Defenses in the Controlling versus Minority Shareholders Context' (2009) 17 Corporate Governance: An International Review 238, 254.

⁴¹¹ Fang Liu, 'Takeover Defenses Under PRC Law(Part I)' (June 2006) China Law & Practice <<http://www.chinalawandpractice.com/Article/1692122/Channel/9939/Takeover-Defenses-Under-PRC-Law-Part-I.html>> accessed 20 April 2013

company.⁴¹² There are 893 listed companies out of 2739 listed companies in which the largest shareholders have less than 25 per cent of total shares. Therefore, some Chinese companies might be exposed to hostile takeovers and deploy some anti-takeover measures to survive. However, according to Article 33 of the Takeover Measures, the following takeover defensive measures are prohibited by law:

1) Issuing shares; 2) issuing convertible bonds; 3) repurchasing shares; 4) amending the target company's articles of association; 5) entering into contracts that could have a material effect on the target company's assets, liabilities, interests or results of operations, except in the ordinary course of business; and 6) disposing of, or purchasing major assets, or changing the target company's principal business, except for changes to business or restructuring of assets carried out by the company experiencing severe financial difficulties.⁴¹³

Even if Article 33 exempted a board of directors from continuing to act as per their pre-existing contracts when facing a hostile bid, directors still need the shareholders' approval under Chinese Company Law, as directors are obliged to manage a company only within a certain remit of the shareholders' authority. Thus, all relevant legislation should adhere to the principles of a shareholder-friendly system of takeover defence regulation.

⁴¹² Cover story, 'Dispersion and Concentration' (2009) 12 Directors & Boards, <<http://www.dongshihui.com.cn/Magazine/ArticleDetail/1599>> accessed 2 May 2016.

⁴¹³ Measures for the Administration of the Takeover of Listed Companies (2008 Revision) a.33 And it is explained by Fang Liu in *Takeover Defenses Under PRC Law* (Part 1)

3) Comparison with the UK's and the US's legal framework

As regards the takeover rules in different legal frameworks, two topics are necessary to consider: the mandatory bid rule, and the wider notion of whom the law protects.⁴¹⁴

Even though the US and the UK have had longer than China to develop their capital market and their relevant regulatory frameworks, their legal systems could not be said to be perfect. Following the revolutions within these two economies, small investors are in need of investor protection more than ever before.⁴¹⁵ Accordingly, all the takeover legislation is aimed at minority shareholders' protection in these countries, and also in China - but the effects of this legislation varies between each market.

As discussed, China's regulatory regime evolved alongside the step-by-step development of her stock market. However, because of multiple factors, China's corporate governance problems are serious, particularly in terms of the limited supervision of management.⁴¹⁶ According to China's Company Law, shareholders have the right and responsibility to monitor directors. However, there are a high percentage of state-owned shares in the market, which makes the state the majority shareholder in many listed companies, and the state can only exercise its rights

⁴¹⁴ Stefan Grundmann, 'The Market for Corporate Control: The Legal Framework, Alternatives, and Policy Considerations' in Klaus J. Hopt and others (eds), *Corporate Governance in Context: Corporations, States, and Markets in Europe, Japan, and the US* (OUP 2005) 423, 424.

⁴¹⁵ David Blake, *Financial Market Analysis* (2nd edn, John Wiley & Sons, LTD 2000) 56.

⁴¹⁶ Junhai Liu, 'Prospect for China's Corporate Law Reform After the Entry into WTO' in Baoshu Wang (ed), *Corporation Law Reform for a Global Competitive Economy* (Social Sciences Academic Press (China) 2003) 254, 270.

through omnipresent bureaucracy, creating the issue of agency costs . Thus, the state can be seen to be non-existent in terms of monitoring the directors of companies in which it is a stakeholder.⁴¹⁷ In China, the state therefore bears the label of a “non-functional proprietor of state-owned shares” (Guoyougu suoyouzhe quewei).⁴¹⁸ In addition, China has a two-tier corporate governance system, which has a special supervisory board to monitor the board of directors of listed companies,⁴¹⁹ but does not practise its responsibilities and serve its ideal function.⁴²⁰ In fact, in China, the supervisory board does not have any actual power in practice, because most supervisory board members do not exercise any supervisory rights except attending board meetings and looking at the financial reports.⁴²¹

a. Lack of legislation

Between 1999 and 2007, the enactment of China’s Securities Law established the legal status of her capital market and pushed the development of relevant legislation.⁴²² Similar to the UK and US, every piece of legislation emerged as a response to a market crisis. The event that pushed China to legitimate its securities

⁴¹⁷ Hehong Cheng, Zhihui Liu and Hongliang Wang, *Study on State-owned Shares* (CUPL Press 2000) 247, 248.

⁴¹⁸ Hui Huang, ‘China's Takeover Law: A Comparative Analysis and Proposals for Reform’ (2005) 30 *Delaware Journal of Corporate Law* 145, 163.

⁴¹⁹ *Company Law of the People's Republic of China* (2005 Revision) a.127.

⁴²⁰ Shenshi Mei, ‘The Roles of Supervisors and Supervisory Board in Modern Corporate Governance’ (1995) 1 *Commercial L Rev* 161, 195.

⁴²¹ Wen Zhao, ‘Research on Supervisory Board and its Implementation of Supervisory Function’ (2002) 2 *Shanghai Management Science* 43, 44.

⁴²² China Securities Regulatory Commission, *China Capital Markets Development Report* (China Financial Publishing House, 2008) 152.

market occurred in 1997, when the number of listed companies and the total turnover increased rapidly,⁴²³ and the relevant legislative framework was improved. China's market experienced remarkably rapid development during that time. However, the stock market itself was a product of other, western countries. The absence of a relevant regulatory regime and the contradiction of incorporating a takeover regime from a totally different legal framework became apparent with the development of the capital market. Research shows that, starting in 2001, China's stock market entered a four-year period of deep change: the index of the stock exchange decreased sharply – the highest point was 2,245.44 in 2001, dropping to 998.23 in 2005.⁴²⁴ At that time, the issue of new shares and refinancing of listed companies became harder. The refinancing period grew longer. Many companies' operations were in trouble and whole industries experienced losses over those four years.⁴²⁵

It is claimed by Hui Huang that China's takeover laws seem to be “both over-inclusive and under-inclusive” in reference to the serious problems associated with takeover defensive tactics.⁴²⁶ Article 33 of the Measures for Regulating Takeovers provided the principles directors should follow, and named six types of takeover defensive measures that were to be prohibited in all circumstances.⁴²⁷

⁴²³ CSRC, Summary for Securities Market (2012).

⁴²⁴ *China Securities Regulatory Commission, China Capital Markets Development Report* (China Financial Publishing House, 2008) 24.

⁴²⁵ *Ibid* 24.

⁴²⁶ Hui Huang, 'China's Takeover Law: A Comparative Analysis and Proposals for Reform' (2005) 30 *Delaware Journal of Corporate Law* 145, 145.

⁴²⁷ Article 33 of the Measures states that: “[t]he measures taken by the directors, supervisors and other senior officials of the target company in response to the takeover activities at issue, shall not damage

However, this was not enough, as takeover measures are not confined to these six types; directors can still use other unregulated measures to defend against a hostile takeover. Thus the law is still “far from perfect, especially in respect of takeover defences”.⁴²⁸ Moreover, it could be seen that China’s prohibition on defensive measures is very specific but the UK’s is very broad, but it is not good for China to copy the UK’s outright prohibition on defensive measures. Because since the UK is a common law system, and the judges can follow the precedent to have their own interpretation of regulations case by case, but China is a civil law system which have to make the regulations as clear as it can to prevent misunderstandings of the regulation.

b. Lack of experience

At first, China’s market was supervised by the State Council Securities Commission (SCSC) and, from 1992, the China Securities Regulatory Commission (CSRC). However, in 1997, after just a few years, there were many securities fraud scandals,

the lawful interests of the target company and its shareholders. After the acquirer makes [a] takeover announcement, the board of directors of the target company can only continue to execute the existing contracts or the resolutions previously made by the shareholder general meeting, and shall not propose the following measures: (1) issue new shares; (2) issue convertible company bonds; (3) buy back its own issued shares; (4) modify the company constitution; (5) enter into contracts which may have material effects on the company’s assets, liabilities, rights, interests or business results, except for the purpose of conducting the ordinary business of the company; [or] (6) dispose of or purchase material assets, or adjust the principal business of the company, save in exceptional situations where the company adjusts the business or restructures the capital when faced with serious financial difficulty.”

⁴²⁸ Hui Huang, ‘China’s Takeover Law: A Comparative Analysis and Proposals for Reform’ (2005) 30 Delaware Journal of Corporate Law 145, 156.

and thus the CSRC merged with the SCSC the next year in order to centralise supervision in one unit.⁴²⁹ The merger of the SCSC and CSRC could be seen as a measure intended to help prevent conflict between the two bodies and properly regulate the market in China. It was also intended to push regional markets to become national, and to supervise the national market uniformly. The CSRC is not like the Takeover Panel in the UK, however. The CSRC is an authority of the state, charged with supervising China's market, and the state's influence cannot be ignored. That is to say, the CSRC is not an independent body, unlike the UK Takeover Panel. The CSRC has a mix of the powers held in the UK by HM Treasury and the Takeover Panel, and has some local branches which are delegated a certain amount of power to resolve some issues. Thus the CSRC is in several respects a more powerful authority than the Takeover Panel. The UK Takeover Code sets out a detailed timetable and provides clear guidance on merger and acquisition activities, and has gathered lots of experience in resolving takeover related issues over past years. However, the UK-style takeover legislation that was transplanted to China was not an exact duplication, but took the form of a revised version with less clear regulations regarding the resolution of issues because of the existence of exemptions. In the UK, the mandatory bid rule provided by the Code preserves a high level of equality among shareholders who participate in the takeover bid, however, China's mandatory bid rule diverges from the law in many aspects, and the most obvious one would be the

⁴²⁹ Ibid 154, 155

wide exemption of mandatory bid rule.⁴³⁰ According to chapter 6 of the Measures, it sets several exemptions which the mandatory bid rule cannot apply.⁴³¹ Even though the UK also provide some exemptions⁴³², China amended the UK rules “in order to serve the purpose of facilitating important types of Chinese takeover transactions to proceed without performing the obligation to make a mandatory takeover bid”.⁴³³ In addition, the CSRC has more freedom to judge whether a situation can be considered an exemption or not, such that a takeover bid might or might not be successful based totally on the will of the state. Moreover, the Chinese supervisory team lacks individuals with professional experience,⁴³⁴ thus the average competence of members to exercise the responsibility of supervising the market is lower than is the case in mature markets, like the UK or US.

A crucial issue in China is that what is written as Chinese law may not be applied in practice, because the government excessively interferes in the market and the growth of Chinese enterprises does not occur in a truly competitive environment.⁴³⁵ The market actually has the ability to self-regulate, and even if it failed to resolve certain issues, would be better to let social organisations, rather than the government, help

⁴³⁰ Juan Chen, *Regulating the Takeover of Chinese Listed Companies: Divergence from the West* (Springer 2014) 67.

⁴³¹ Measures for Administration of the Takeover of Listed Companies (2008 Revision) a.62, and a. 63.

⁴³² The Takeover Code 2013, Notes on Dispensations from Rule 9.

⁴³³ Juan Chen, *Regulating the Takeover of Chinese Listed Companies: Divergence from the West* (Springer 2014) 72.

⁴³⁴ Bin Qi, ‘Ziben Shichang yu Zhongguo Jingji Shehui Fazhan [Capital Market and the Development of China's Economic Society]’ (2012) 26(9) China Business and Market 13, 19.

⁴³⁵ Tan Lay Hong, ‘Corporate Governance Issues in PRC Companies’ (2000) 11(3) ICCLR 94,95.

first. That said, the market has its own defects in terms of allocating resources, and the government could be more effective in helping to fix that problem to some extent.⁴³⁶ One thing should be adhered to is that the government should not interfere in the market without limits, otherwise the market cannot play its own statutory role. Unfortunately, China's government frequently intervenes in the market. For example, it is argued that China's government cannot provide a competitive environment in certain industries, such as electronics or water supply because of its national monopoly.⁴³⁷ The government has also tried to interfere in the market over administrative measures, rather than helping the market resolve problems that it cannot resolve it itself.⁴³⁸ In this way, China's government controls aspects of the market and restricts its ability to perform freely. To continue the reform of China's capital market and to perfect relevant legislative and supervisory systems, the market needs to be opened further and become more internationalized.⁴³⁹ If China wants to achieve the goal of building a more effective market, it should open its market and limit administrative intervention in market activities. Otherwise, it is difficult to claim that China has a sufficiently sound market for advanced, western-style market strategies because of the level of government intervention. Thus, there is still a long

⁴³⁶ Lulu Liu, 'The Analysis of Necessity and Limits of Government Intervention in the Market' (2013) 12 Knowledge and Economic 6, 6.

⁴³⁷ Junhao Wang, 'On Policy Thoughts of Deepening Reform in China's Monopoly Industries' (2009) 9 China Public Administration 9, 10.

⁴³⁸ Xuekun Wang, 'Research on Problems and Solutions of Our Government Intervention in the Market Economy [Woguo Zhengfu Ganyu Shichang Jingji de Wenti yu Duice Yanjiu]' (2012) 20 Technology Information 101, 102.

⁴³⁹ China Securities Regulatory Commission, *China Capital Markets Development Report* (China Financial Publishing House, 2008) 78.

way to go to strengthen the quality of supervision in China and facilitate the healthy development of the Chinese market.

4. Summary

To summarize, transplanting western-style takeover legislation to a totally different market is no easy thing. There does not exist a perfect legislative system that can fit any market in the world; a regulatory system should be based on an analysis of market structure and legislative environment for specific economies - like China. This chapter sought to establish the distinctive features of the UK and US markets, and in particular, their takeover regulation systems, and then looked to analyse the reasons for which certain systems fit the Chinese market better.

Regarding market structure, the UK's market is occupied by a large number of institutional investors, which is a strength over a market dominated by household investors. As discussed previously, institutional investors are more active in managing listed companies. At the same time, since most institutional investors' portfolios include insurance companies, retirement or pension funds, etc., they are more professional in terms of business acuity, and more well equipped to participate in the corporate governance of listed companies. Consequently, institutional investors as majority shareholders in listed companies are more apt to make the right choice(s) when they are facing a tender offer or a hostile bid. Thus, the UK's

shareholder-friendly takeover legislation system fits the UK's market and ownership structure. Furthermore, the Takeover Panel, an independent institution charged with resolving takeover issues, is considered to be effective and professional, and can offer support regarding the implementation of relevant legislation. In addition, as most investors seek to maximise the profit from their investment, they are likely to prefer bids with a high premium, and the UK's rules give them the freedom to decide which these are.

The US market is similar but not identical to the UK's, so the legislative intent is different. The US ownership structure is highly dispersed, and there are more household investors in the US market who typically have more limited professional skills and experience in managing a company. Thus, trusting professional directors could be a better choice for listed companies' corporate governance in such an open, advanced and competitive market as the US. The US has also set up duties and responsibilities in its legislation to ensure that directors act with good will to fight for shareholders' interest. Thus, the US takeover regulations are much more director-friendly, and may be beneficial for the development of the market in putting companies into professionals hands. Moreover, the US legal framework is more complicated than that of the UK or China because of the existence of blue-sky laws and the three levels of supervision in the US. The statutory system could be really helpful for solving the issues of daily transactions. The system of self-regulation cannot work well without professional members with more experience in a mature market with a long history of development, however. Most of the issues related to

takeover activities may only be brought to court for a final judgement, which could involve waiting for a long time, and by this measure, it could be claimed that the US system is less effective than the UK system in resolving serious disputes. That said, no system is perfect, yet the current US system seems an apt one for a market with the aforementioned features.

Both the UK and US experienced a change from private markets to more public ones. During their periods of change, both countries' legislators focused on the protection of minority shareholders, given the large number of minority shareholders in their markets. In addition, the market-oriented principles of these two countries made the markets more active as a result, and able to act and develop without governmental interference.

China's market is young and it has some features that make attempts to transplant a western-style legislative system complicated. The major barriers are the concentrated ownership structure and the special shareholder in the Chinese market - the state. The market was designed to resolve the financing problems of SOEs, so has a very different origin to the UK and US markets. China has introduced a system that combines US- and UK-style regulatory systems; this has been criticized by scholars as having many defects, however. In addition, the CSRC, the Chinese supervisory authority, is not like the UK Takeover Panel in the sense of being an independent department that acts to resolve all issues without consideration of the will or preferences of government. It has been argued by Chinese scholars that the capital

market should be made freer through reducing governmental interference, perfecting the supervisory system, and increasing the professional quality of the supervisory team members.⁴⁴⁰ Scholars have also argued that China cannot improve on the inefficiency of SOEs by using western-style systems of regulation “unless the State withdraws [from] or considerably reduces its ownership [of] the large number of State-owned listed companies”.⁴⁴¹ If the percentage of shares held by the state remains at the current (high) level, western-style takeover regulation cannot work.⁴⁴² That is to say, the rules would only exist in name, but could not work in practise. It is also important to note that “the adoption of a specific takeover rule may lead towards more dispersed ownership ... and the takeover regulation reforms that enhance investor protection are likely to lead towards more dispersed ownership.”⁴⁴³ That is not to say that the transplanting of a western-style system would totally change the ownership structure in China now, but that the influence of a legislative framework matters for the development of China’s market. Based on the effort put into market development over recent years in China, it seems fair to conclude that the SOEs are still reforming and that the Chinese market may be more open and more effective in the future.

⁴⁴⁰ Tao Zhang, ‘Empirical Study on the Effectiveness of Split-share Structure Reform on China’s Stock Market’ (2008) 3 Jianghai Academic Journal 75, 80.

⁴⁴¹ Guanghua Yu, ‘The Problem with the Transplantation of Western Law in China’ <<http://ssrn.com/abstract=1535683>> accessed 22 April 2013 2.

⁴⁴² Ibid 19.

⁴⁴³ Marc Goergen, Marina Martynova and Luc Renneboog, ‘Corporate Governance Convergence: Evidence from Takeover Regulation Reforms in Europe’ (2005) 21 Oxford Rev of Econ Policy 243, 268.

This chapter has considered how the historical development of markets influence their features, and that relevant legislation and market development have a synergistic, symbiotic relationship as the development of one pushes the advance of the other. Both the US and UK markets are international and are have grown to become the most advanced in the world through the aid of appropriate regulations. That does not mean that their rules will work in the same way in China. Considerations of cultural, and environmental differences should come ahead of a simple transplant of regulations.

The next chapter will focus on the introduction of markets and their legal frameworks, establish the preconditions for regulating takeover defensive measures, and discuss and suggest how to transplant western takeover rules to China and which measures should be prohibited, and which should be allowed.

Chapter 4: Takeover defence tactics relating to stock trading

Executive Summary

We have now examined the different takeover markets apparent in three jurisdictions – the UK, US and China. We have also examined the way these markets are regulated. The following three chapters will focus on takeover defence measures, and consider their features in order to find establish whether any these measures might fit China's market. To better discuss them, this thesis will classify all takeover defence measures into one of three categories: 1) takeover defence tactics relating to stock trading, 2) takeover defence tactics relating to management, and 3) takeover defence measures relating to litigation and similar tactics. Each chapter will discuss the features of a specific tactic, and how this tactic would work. Case studies will also be included for a better understanding of how the tactics work, followed by a discussion of the advantages and/or disadvantages of each tactic in order to conclude whether they should be legalised in China. While most of these defence tactics are legal in the US, the UK prohibits most of them, and has a takeover-friendly regulatory system. The case studies and discussion in the following chapters will therefore draw reference more from the US than the UK for a better understanding of how these measures work.

This chapter will introduce four major takeover defensive measures relating to stock trading. First, it will discuss share repurchase and greenmail tactics' features and

cases, and argue that greenmail, as a special kind of share repurchase method, is a high-risk measure to defend against hostile takeovers; thus, most systems prohibit it. China has prohibited the greenmail tactic as well, and similar share repurchase activities are highly restricted.

Secondly, the chapter will introduce the Pac-man tactic and related cases, and will argue that the Pac-man defence is also risky because it requires the target to have sufficient funding to finance a reverse takeover against the hostile bidder and may be harmful to both the target and bidder during the defensive process. Nonetheless, the potential benefits of this defensive tactic are acknowledged by the US, and so it is not prohibited.

Thirdly, the chapter will discuss white knight, grey knight, and white squire tactics, with reference to related cases. These tactics are low-risk and easier to deploy because they are tactics, which depend upon seeking allies to help the target defend against a hostile bidder, and so may fit in any market. They are legal in all three countries. However, one significant problem the white knight tactic gives rise to is the possibility that a business ally may turn into a hostile bidder. That said, this risk is not sufficient to affect the legality of the white knight defence.

Finally, the chapter will discuss crossholding and ESOP tactics, other effective defensive measure that could be deployed in any market because of their user-friendly features. The crossholding tactic could make the shareholding structure in a target company more complicated, and reduce the likelihood of a hostile take over, while

ESOP could increase employees' engagement to the company as well as lower the risk of hostile takeovers. These two measures could both be deployed in China, and ESOP is, in fact, now encouraged there.

1. Share Repurchase (Greenmail)

1) Definition & Features

Share repurchase is a tactic whereby a target company repurchases its shares when faced with a hostile takeover, and by doing so, reduce the amount of total public shares and increase the share price to make the takeover harder than before.⁴⁴⁴ Share repurchase can be achieved via two methods: “greenmail” and the “dead swap”.⁴⁴⁵

The negotiated share repurchase is often called “greenmail”, used to describe a target company's purchase of “its own common stock at a premium above the current price” when they are faced with a hostile takeover offer.⁴⁴⁶ It is aimed at “avoiding an inadequately priced coercive takeover offer and removing the threat of a destructive

⁴⁴⁴ Liang Huang, *A Study on the Legal Regulation of Anti-takeover of Listed Corporations* (Jilin University 2010) 66.

⁴⁴⁵ Ibid 66.

⁴⁴⁶ Jonathan R. Macey and Fred S. McChesney, ‘A Theoretical Analysis of Corporate Greenmail’ (1985) 95 *The Yale Law Journal* 13, 13.

control contest” by repurchasing shares from dissident shareholders.⁴⁴⁷ It has also been called a “targeted stock repurchase” or a “goodbye kiss” by some scholars.⁴⁴⁸

Greenmail was controversial during the 1980s and 1990s,⁴⁴⁹ and due to the enactment of anti-greenmail and other related anti-takeover statutes and some adverse tax laws⁴⁵⁰ on the receipt of greenmail payments, most of the present discussion of greenmail tactics is provided solely an historical background of the development of takeover defence tactics in the US.⁴⁵¹

2) How it works

Generally, the target company could pay some shareholders cash to retain their shares in the target company. However, greenmail and the dead swap are (were) two special ways of repurchasing those shares. To be specific, greenmail relates to attempts to buy the target’s shares at a premium through signing a contract with the hostile bidder to ensure that bidder will stop acquiring the target’s shares. This could also be called a

⁴⁴⁷ Stephen Kenyon-Slade, *Mergers and Takeovers in the US and UK : Law and Practice* (OUP 2004) 405.

⁴⁴⁸ Larry Y. Dann and Harry DeAngelo, ‘Standstill agreements, privately negotiated stock repurchases, and the market for corporate control’ (1983) 11 *Journal of Financial Economics* 275, 275.

⁴⁴⁹ Stephen Kenyon-Slade, *Mergers and Takeovers in the US and UK : Law and Practice* (OUP 2004) 405.

⁴⁵⁰ The legislation includes H.R. 5693, 98th Cong., 2d Sess., H.R.5694, 98th Cong. 2d Sess., and H.R.5695 98th Cong., 2d Sess.,130 Cong Reg. H4537-60 (daily ed. May 22 1984) and is aimed at addressing various problems posed by defensive measures. Also, the *Internal Revenue Code* places tax punishments on greenmail payments.

⁴⁵¹ Stephen Kenyon-Slade, *Mergers and Takeovers in the US and UK : Law and Practice* (OUP 2004) 405.

“stand-still agreement” or “stand-still contract”.⁴⁵² A dead swap is (was) more complicated than greenmail. In a dead swap, the target company issues company debts, special shares or a combination of both, to exchange with publically-listed shares so as to reduce the total amount of such shares; meanwhile, this measure will also help increase the share price and increase the hostile bidder’s takeover cost.⁴⁵³

3) Case study

In the case *Unocal vs. Mesa*,⁴⁵⁴ hostile bidders, who were also shareholders in the target company, were excluded from the list of those whose shares could be repurchased by the target company. That is to say, the hostile bidders could not enjoy the premiums the target company offered to shareholders to increase the target company’s holding ratio of shares. However, shortly after that, the SEC revised relevant rules to ensure the equal treatment of all shareholders.⁴⁵⁵

Research has shown that, from 1983 to 1984, four billion US dollars were paid by target companies to repurchase their stock from individual shareholders; some of the companies paid the shareholders good premiums - for example, Warner

⁴⁵² Liang Huang, *A Study on the Legal Regulation of Anti-takeover of Listed Corporations* (Jilin University 2010) 66.

⁴⁵³ Wan Xiao, ‘Shangshi Gongsi Gufen Huigou de Fan Shougou Shiyong Tansuo [Research on the Takeover Defense of Share Repurchase by Listed Companies]’ (2009) 1 Finance and Accounting Research 25.

⁴⁵⁴ *Unocal Corp. v. Mesa Petroleum Co.* (493 A.2d 946(1985)).

⁴⁵⁵ Bo Wei, ‘Analysis on Validity of Anti-Takeover Measures by Target Company’ (Master's thesis, ECUPSL 2011) 22-23.

Communications paid Rupert Murdoch and Saul Steinberg greenmail regarding an agreement with Walt Disney Productions.⁴⁵⁶

4) Discussion of strengths and weaknesses

Naturally, a target company's cash flow is influenced by repurchasing shares from shareholders, and this influence can be negative. Moreover, whilst a dead swap might limit or negate any negative effect on the target company's cash flow, it may incur the high risk that results from increased levels of debt. Even more importantly, there is the key issue of managers' abuse of power in repurchasing shares during the takeover process. Consequently, China's Company Law does not allow share repurchase with the reason of defending a hostile bidder.⁴⁵⁷ Also, in the UK it is restricted by the Code.⁴⁵⁸ Moreover, share repurchase tactic will be evaluated under *Unocal* standard of review if it is adopted in the US since it has a powerful anti-takeover effect.⁴⁵⁹

Ultimately, there are scholars who support greenmail and those who are against it. On the one side, scholars who have advocated for the existence of greenmail suggested that there was never any requirement of the law that the shares should be purchased at

⁴⁵⁶ Jonathan R. Macey and Fred S. McChesney, 'A Theoretical Analysis of Corporate Greenmail' (1985) 95 The Yale Law Journal 13, 14. "Warner Communications' repurchase of 5.6 million of its shares from Rupert Murdoch at 33 per cent above the market price"; Saul Steinberg's greenmail agreement with Walt Disney Productions was at 77.5 US dollars per share when the market price was only 65.13 US dollars per share ...And it was perhaps the best-publicized negotiated repurchase of all."

⁴⁵⁷ Company Law of the People's Republic of China (2005 Revision) a.143.

⁴⁵⁸ The Takeover Code 2013 Rule 21.1.

⁴⁵⁹ See *Shamrock Holdings, Inc. v Polaroid Corp* 559 A. 2d 278, 289 (Del. Ch. 1989) and *Unocal Corp. v. Mesa Petroleum Co.* 493 A.2d 946(1985).

an “equal term or in equal amounts for all shareholders”, and that share premiums were not part of the corporate assets which shareholders should own equally.⁴⁶⁰

On the other side, it is thought that, due to the share price decline that may follow greenmail, prohibition of the tactic could, as a consequence, enhance shareholders’ wealth.⁴⁶¹ Moreover, the greenmail payments are highly likely to cause a problem of “free-rider” as the information is released through triggering the hostile bid by the initial bidder, and other shareholder could enjoy the premium the target company offered except the initial hostile bidder.⁴⁶² In other words, this payment placed the hostile bidder, who is also one of the investors in the target company, in a really disadvantaged position in trading the shares.

The practice of making a lump sum payment to a firm or individual in exchange for an agreement not to proceed with a tender offer, even when no purchase of stock is made, is also referred to as greenmail. When the agreement freezes a shareholder's interest at a certain percentage, it is known as a "standstill agreement." These

⁴⁶⁰ Stephen Kenyon-Slade, *Mergers and Takeovers in the US and UK : Law and Practice* (OUP 2004) 408.

⁴⁶¹ B. Espen Eckbo, ‘Valuation Effects of Greenmail Prohibitions’ (1990) 25 *The Journal of Financial and Quantitative Analysis* 491, 504.

⁴⁶² Jonathan R. Macey and Fred S. McChesney, ‘A Theoretical Analysis of Corporate Greenmail’ (1985) 95 *The Yale Law Journal* 13, 28 and Roger J. Dennis, ‘Two-Tiered Tender Offers and Greenmail: Is New Legislation Needed?’ (1985) *Ga L Rev* 281, 331. According to Dennis’s research, in 75 per cent of mergers and acquisition activities that had competitive bids, the initial bidder failed to achieve its goal to take over the target company. If greenmail payment was made after the hostile bidder announced its intention, the rest of the shareholders could free-ride on the situation generated by the hostile bid and enjoy the premiums paid by the target company, while the bidder took a risk by announcing and may possibly receive nothing back.

agreements are generally thought to be equivalent to greenmail, which also stipulates the permissible ownership of the contracting shareholder, but sets it at zero.⁴⁶³

It has been argued that the greenmail tactic can help “to facilitate management entrenchment at shareholders’ expense”,⁴⁶⁴ so many scholars were (are) against the use of this tactic. However, there are others, such as Shleifer and Vishny, who challenge the traditional perspective of greenmail’s negative effect on the share price. They found that the share price always falls after the payment of greenmail, whether the managers were maximizing the long-term value of the target company or not. Thus, the performance of share prices could be seen only as a reflection of certain management actions and should not be used to judge the effectiveness of greenmail as a takeover defence measure.⁴⁶⁵ It can also be argued that greenmail imparts some benefits to target shareholders, but that this can be abused sometimes. Thus, overall, it is hard to tell whether greenmail is definitely harmful to shareholders’ interests.

Most scholars have agreed that takeover defensive measures are useful tools for managers to protect their power over the target company.⁴⁶⁶ However, numerous

⁴⁶³ Jonathan R. Macey and Fred S. McChesney, ‘A Theoretical Analysis of Corporate Greenmail’ (1985) 95 *The Yale Law Journal* 13 note 1.

⁴⁶⁴ Andrei Shleifer and Robert W. Vishny, ‘Greenmail, White Knights, and Shareholders’ Interest’ (1986) 17 *The RAND Journal of Economics* 293, 294.

⁴⁶⁵ *Ibid* 295.

⁴⁶⁶ Michael C. Jensen and Richard S. Ruback, ‘The Market For Corporate Control: The Scientific Evidence’ (1983) April *Journal of Financial Economics* 36, 39. In this thesis, the authors described the negative returns brought by the managers using takeover defensive tactics such as standstill agreements and share repurchase. These actions, relating to takeovers, will harm shareholders’ interests, according to the authors’ research.

studies have shown various drawbacks to greenmail. For example, data indicate that the “share price always declines when greenmail is paid, despite the fact that target management is acting in the interest of its shareholders.”⁴⁶⁷ Additionally, a standstill agreement may only serve to inform the other potential hostile bidders that the target company is weak.⁴⁶⁸

Meanwhile, from Eckbo’s research, it could be concluded that greenmail could be influenced by other takeover defensive measures, such as a standstill agreement deployed by the target company and the negative effects cannot be calculated precisely.⁴⁶⁹ Furthermore, it was also found that greenmail payments may “reduce the expected return to another important group of players in the takeover market: the arbitrageurs”.⁴⁷⁰ It is argued that the arbitrageurs sometimes has certain amount of the target company’s shares which is willing to be sold to the target company at a premium if greenmail tactic is used. Thus the arbitrageurs could make profits by buying and selling shares at different prices even if they do not anticipate completing the takeover.⁴⁷¹

⁴⁶⁷ Andrei Shleifer and Robert W. Vishny, ‘Greenmail, White Knights, and Shareholders’ Interest’ (1986) 17 The RAND Journal of Economics 293, 308.

⁴⁶⁸ Ibid 308.

⁴⁶⁹ B. Espen Eckbo, ‘Valuation Effects of Greenmail Prohibitions’ (1990) 25 The Journal of Financial and Quantitative Analysis 491, 505.

⁴⁷⁰ Ibid 505. In this article, it is stated that “the activity of arbitrageurs has the important effect of lowering transaction costs of both financing and executing takeovers”. The broader impact of paying greenmail to arbitrageurs is a regulation issue, which is not entirely relevant to this thesis, however, and so will not be discussed.

⁴⁷¹ Jeff Madura, *Financial Institutions and Markets* (8th edn, Thomson 2008) 655.

Objectively speaking, greenmail is not always harmful to the target company; as discussed previously, and as Macey and McChesney have argued, some greenmail payments have benefitted shareholders, and need to be distinguished.⁴⁷² It could be concluded from their research that, with the help of business judgement rules, managers' power to abuse greenmail payment is as limited (and difficult) as possible, and that the benefits of paying greenmail should not be ignored by regulators. Indeed, greenmail may boost total company wealth by increasing the share price and so "perform an important social function".⁴⁷³ Ultimately, the vast majority of empirical studies suggest that once greenmail payments are made by a target company, the share price of the target company will experience an immediate decrease.⁴⁷⁴ However, general share repurchases without any discrimination between the hostile bidder and other shareholders could help increase market share price.⁴⁷⁵

In addition, greenmail payments may provide a catalyst for a turnover in the target company's management (as the payment might be taken as a signal of poor management).⁴⁷⁶ To discourage the payment of greenmail, the US government

⁴⁷² Jonathan R. Macey and Fred S. McChesney, 'A Theoretical Analysis of Corporate Greenmail' (1985) 95 *The Yale Law Journal* 13, 16. In this article, the authors clarified that they are not writing to advocate greenmail payments, and that greenmail can be abused or impose unacceptable agency costs. Rather, they believe in those transactions that are beneficial to the shareholder.

⁴⁷³ *Ibid* 28.

⁴⁷⁴ Can be found in Note, 'Greenmail: Targeted Stock Repurchases and the Management Entrenchment Hypothesis' (1985) 98 *Harv L Rev* 1045, 1056.

⁴⁷⁵ Michael Bradley and L. Macdonald Wakeman, 'The Wealth Effects of Targeted Share Repurchase' (1983) 11 *J Fin Econ* 301,328.

⁴⁷⁶ April Klein and James Rosenfeld, 'Targeted share repurchases and top management changes' (1988) 20 *Journal of Financial Economics* 493, 506.

created a tax punishment applied to the receipt of it. According to the Internal Revenue Service, a tax equal to 50 per cent of gain is levied on greenmail payments,⁴⁷⁷ imposed as a penalty once the greenmail is enacted.⁴⁷⁸

It could be said that the benefits of the greenmail payment is old-school, but that it still needs to be discussed as a relevant defensive measure because China need to take a clear position on its availability. According to China's contemporary legislation, the share repurchase requirements in China's Company Law 2005 are less strict than the previous version of Company Law but the greenmail payments are still not available in China.⁴⁷⁹

2. Pac-man

1) Definition & Features

Pac-man is a defence tactic that can reverse the positions of the bidder and the target. The Pac-man defence was named after an electronic game that was quite popular at the beginning of 1980s. In that game, the electric animals fight against each other and one that fails to eat its enemy it will be eaten by its enemy in return. Since the Pac-man defence was aimed at the original offeror so as to defend against the hostile

⁴⁷⁷ According to section 5881 of the *Internal Revenue Code*: "There is hereby imposed on any person who receives greenmail a tax equal to 50 per cent of gain or other income of such person by reason of such receipt."

⁴⁷⁸ Patrick A. Gaughan, *Mergers, Acquisitions, and Corporate Restructurings* (5th edn, John Wiley & Sons 2010) 621.

⁴⁷⁹ Company Law of the People's Republic of China (2005 Revision) a.143.

takeover, it is understandable that commentators named this anti-takeover measure after that famous game.⁴⁸⁰

2) How it works

Pac-man defence tactic was the strategy used by the target to reverse the role in a takeover battle. The target company could offer the hostile bidder a tender offer to acquire its shares or tender certain benefits to the possible white knight to acquire the hostile bidder's shares together to take over the hostile bidder company.⁴⁸¹ If the Pac-man defence is to be deployed by the target company, certain issues should be considered first relating to financing the purchase of the hostile raider's shares. To be specific, the premium ratio over the market price of the hostile bidder's shares should be decided, the total capital required to purchase the shares should be calculated, and most importantly feasible ways to make, or borrow the required funds.⁴⁸²

3) Case study

⁴⁸⁰ Yungeng Xie, 'Media Takeover and Anti-takeover [Chuanmei Binggou yu Fan Binggou]' (*People.com*, 7 July 2005) <<http://media.people.com.cn/GB/40628/3524651.html>> accessed 01 Aug 2013.

⁴⁸¹ Lynden Griggs, 'Golden Parachutes, Crown Jewels and the Arrival of the White Knight - Strategies to Defeat A Hostile Takeover. What Use in An Era of Rigorous Enforcement of Directors' Duties' (1998) 5 *Canberra L Rev* 203, 216.

⁴⁸² These questions concerned here could be found in the script of program presented by the Section of Litigation at the 1983 annual meeting of the American Bar Association in Atlanta. Even if it is an edited script, the uses of some of the defensive tactics are better illustrated through that way presented by the American Bar Association. For more details, see R. Todd Lang and others, 'PART 2: The Dramatization of a Hostile Tender Offer' (1984) 70 *ABA Journal* 72, 77.

Pac-man defence attracted heated debate in the 1980s, it was said to be aimed at threatening the hostile bidders, but was implemented used, so the number of successful cases is limited.⁴⁸³ In 1982, there was a very famous hostile takeover case involving Bendix,⁴⁸⁴ Martin Marietta,⁴⁸⁵ Allied Corporation⁴⁸⁶ and United Technologies.⁴⁸⁷ In that case, the target Martin Marietta teamed up with United Technologies and used the Pac-man defence in attempting to acquire the stocks of the hostile bidder – Bendix. In order to finance the purchases of Bendix's shares, the debt of Martin Marietta was increased, followed by a lower book value, and reduced bond rating.⁴⁸⁸ At the same time, there was a white knight company invited by Bendix – the Allied Signal Corporation. At that time, while the previous hostile bidder was defended by the target's Pac-man defence, the hostile bidder became a target as well. To defend against Martin Marietta, Bendix invited Allied Signal to help purchase

⁴⁸³ Patrick A. Gaughan, *Mergers, Acquisitions, and Corporate Restructurings* (5th edn, John Wiley & Sons 2010) 238.

⁴⁸⁴ Bendix is an American manufacturing and engineering corporation active since the 1970s, and since 2002, has been a subsidiary of Knorr-Bremse since 2002. More information can be found at http://www.bendix.com/en/aboutus/history/history_1.jsp Accessed 26 December 2013.

⁴⁸⁵ Martin Marietta Materials has been the second largest producer of construction aggregates since the 1960s. Details about the company can be found on its official website: <http://www.martinmarietta.com/Corporate/profile.asp> accessed 26 December 2013.

⁴⁸⁶ Allied Chemical & Dye Corporation was previously only active within the chemical industry but became involved in aerospace during their merger with Bendix. It is now part of a Fortune 100 company, Honeywell. The company history can be found at <http://honeywell.com/About/Pages/our-company.aspx> accessed 26 December 2013.

⁴⁸⁷ "United Technologies Corporation is a diversified company that provides a broad range of high-technology products and services to the global aerospace and building systems industries." More information could be seen on its official website www.utc.com accessed 26 December 2013.

⁴⁸⁸ Kenneth C Johnsen, 'Golden Parachutes and the Business Judgment Rule: Toward a Proper Standard of Review' (1985) 94 *The Yale Law Journal* 909, 919.

shares of Bendix and won control of the company.⁴⁸⁹ Through this takeover activity, the white knight Allied Corporation did benefit from it and gained valuable Bendix assets.

There were also cases showing that the result of using Pac-man defences was not a real success in the end in the US. As in the takeover case between Mesa and Cities Service, it was said that the target company Cities Service fought back against the hostile bidder Mesa through Pac-man defence. This defence did work and benefited Cities' shareholders.⁴⁹⁰ However, the claimed winner of the hostile battle, Cities Service ended up being taken over by Occidental Petroleum.

The most recent case in America began in November 2013 between Men's Wearhouse and Jos. A. Bank – two leading clothing retailers in the US.⁴⁹¹ In November 2013 Jos. A. Bank announced an offer to Men's Wearhouse of 2.6 billion USD, which is rebuffed by the target company.⁴⁹² Shortly after the hostile bid was launched, Men's Wearhouse announced a 1.5 billion USD offer to its rival Jos. A.

⁴⁸⁹ Patrick A. Gaughan, *Mergers, Acquisitions, and Corporate Restructurings* (5th edn, John Wiley & Sons 2010) 241.

⁴⁹⁰ Gregory Corcoran, 'The Dangers of the Pac-Man Defense' (*The Wall Street Journal*, 2007) <<http://blogs.wsj.com/deals/2007/11/15/the-dangers-of-the-pac-man-defense/>> accessed 22 December 2013.

⁴⁹¹ Liz Hoffman, 'Back to the '80s: The Pac-Man Defense' (*The Wall Street Journal*, 26 November 2013) <<http://blogs.wsj.com/moneybeat/2013/11/26/back-to-the-80s-the-pac-man-defense/>> accessed 22 December 2013.

⁴⁹² Chris Peters, 'Men's Wearhouse Mounts Hostile Takeover Bid For Rival Jos. A. Bank' (*Reuters*, 6 January 2014) <http://www.huffingtonpost.com/2014/01/06/mens-wearhouse-hostile-takeover-jos-a-bank_n_4547733.html> accessed 08 January 2014.

Bank for its shares,⁴⁹³ which made the Pac-man defence tactic attract the public's attention again. Shortly after the defensive measure was taken, in January 2014 the target company Men's Wearhouse raised its bid for Jos. A. Bank and it could be seen that this hostile battle caused the target's share price to increase and the hostile bidder's share price experienced a slight decline.⁴⁹⁴ Finally, the target successfully acquired the bidder in 2014 after few months' negotiations.⁴⁹⁵ And for now, this defensive measure could be seen as a successful one.

4) Discussion and summary

Currently, there is no regulation prohibit the use of Pac-man defence in China. However, since Pac-man includes the investment of the bidder company, it is not easy for the target company to succeed if it has the difficulty of financing. Also, in the UK, the Code requires the directors get the shareholders' approval "(iv) sell, dispose of or acquire, or agree to sell, dispose of or acquire, assets of a material amount; or (v) enter into contracts otherwise than in the ordinary course of business"⁴⁹⁶ when the

⁴⁹³ Liz Hoffman, 'Back to the '80s: The Pac-Man Defense' (The Wall Street Journal, 26 November 2013) <<http://blogs.wsj.com/moneybeat/2013/11/26/back-to-the-80s-the-pac-man-defense/>> accessed 22 December 2013.

⁴⁹⁴ Chris Peters, 'Men's Wearhouse Mounts Hostile Takeover Bid For Rival Jos. A. Bank' (Reuters, 6 January 2014) <http://www.huffingtonpost.com/2014/01/06/mens-wearhouse-hostile-takeover-jos-a-bank_n_4547733.html> accessed 08 January 2014.

⁴⁹⁵ Brent Kendall and Dana MAttoli, 'FTC Approves Merger Between Men's Wearhouse, Jos. A. Bank: Commission Grants Antitrust Clearance to the Planned Merger of Men's Clothiers' *The Wall Street Journal* Business Section (30 May 2014).

⁴⁹⁶ The Takeover Code 2013 rule 21.1.

action may result in any offer or bona fide possible offer being frustrated.⁴⁹⁷ So as a post-bid defensive tactic, the Pac-man defence would only be used if the directors get the shareholders' approval.

It is possible that use of the Pac-man defence could result in either the take over of the hostile bidder company by acquiring its shares or abandonment by the hostile bidder of its original intention. However, both of the possibilities were based on the premise that the target and the hostile bidder were not quite different in sizes, financing abilities, etc.; that is to say that the target could possibly threaten the hostile bidder by threatening to acquire it. If the target did not have this ability at all, the Pac-man would not be able to work in effect.

Also, it is hardly to say that Pac-man defence is a better strategy even if the target has the power to take over the hostile bidder, because it could harm both of the target and the bidder at the same time. First of all, one key problem of the target company is how to finance the purchase of the hostile bidder's shares. As it is shown in the cases, the capital required for the purchase of the hostile bidder's shares is potentially huge. And if the target company does not have sufficient capital to finance Pac-man defence, not only could the use of the defence fail, but also the interests of shareholders might be harmed because of the possibility of a share price decline during the defensive process.

⁴⁹⁷ Ibid Rule 21.

Furthermore, there were many scholars who were against the internecine Pac-man defence since it may cause many problems.⁴⁹⁸ For example, a successful Pac-man defence may result in a crossholding structure between the hostile bidder and the target, where these shares purchased by each other have voting rights.⁴⁹⁹ Especially in the US, the cross holding could be more complicated if the two companies are located in two different states, because the regulations of exercising these voting rights could be different. Consequently, allowing the companies to use Pac-man defence created a threat to the efficiency of US's corporate law.⁵⁰⁰

Consequently, it could be seen that the Pac-man defence is a high-risk measure to fight against the hostile bidder. And if the decision right is in the directors' hands, legislation, such as in the US, should help to guarantee the board of directors was behaving in the shareholders' interests in taking such high risk measures to save the target company. Moreover, the SEC used to consider a prohibition of Pac-man defence but did not pursue this idea because the SEC commissioners admitted the benefits to of shareholders in certain circumstances when using the Pac-man defence, even if it can be a "cause for 'serious concern'".⁵⁰¹

⁴⁹⁸ Deborah A de Mott, 'Pac-Man Tender Offers' (1983) 32 Duke Law Journal 116,116.

⁴⁹⁹ Ibid 117.

⁵⁰⁰ Ibid 130.

⁵⁰¹ Gregory Corcoran, 'The Dangers of the Pac-Man Defense' (The Wall Street Journal, 2007)

<<http://blogs.wsj.com/deals/2007/11/15/the-dangers-of-the-pac-man-defense/>> accessed 22 December 2013.

3. White knight, Grey Knight and White Squire

1) Definition & Features

Some hostile takeovers involve more than one hostile bidder, which means that other bidders may enter the takeover battle after the original bid is announced. If the potential acquirer is recommended to raise its initial offer by the target company, this alternative bidder could be seen as the cause.⁵⁰² Similar to the white knight, the White squire is also an ally of the target company who will acquire a specific amount of stock of the target company, but not a sufficient amount to control the whole target company. Unlike the white knight, who may take over the target company and break the hostile bidder's takeover plan, the white squire will only help the target company secure a certain percentage of shares and prevent the hostile takeover by working alongside the target board.⁵⁰³ There may also be some restrictions placed on the shares tendered to the White squire, such as a bar on selling them to a third party, but the white squire will nonetheless benefit from a discounted share price or a seat on the target's board⁵⁰⁴ through helping the target company.

⁵⁰² Tim Jenkinson and Colin Mayer, *Hostile Takeovers, Attack and Corporate Governance* (McGRAW-Hill Book Company Europe 1994) 32.

⁵⁰³ J. Fred Weston, Mark L. Mitchell and J. Harold Mulherin, *Takeover, Restructuring, and Corporate Governance* (4th edn edn, Prentice Hall 2003) 89.

⁵⁰⁴ Markus Johansson and Martin Torstensson, 'Hostile Takeovers: The Power of the Prey' (Masters Thesis, Jönköping International Business School 2008) 15.

In some cases, the white knight may also use the so-called “Lady Macbeth strategy”⁵⁰⁵ whereby they pretend to be friendly to the target company and then change to be a Grey Knight. That is to say, after the initial hostile bidder is rejected by the target company, the erstwhile white knight will become a hostile bidder of its own.⁵⁰⁶

An important fact that should be pointed out is that neither the white knight nor the white squire are totally selfless: The decision to help the target company to get rid of the risk of being taken over by a hostile bidder is likely to be motivated by the possibility of returns from the target company (such as the aforementioned best price for shares, or board seat). However, such preferential terms could be in breach of the target company director’s duties to the company’s shareholders. Thus, the directors usually attempted to make an agreement with the white knight – for example, a white-knight-leveraged buyout⁵⁰⁷ - to achieve both maximum gain for the target company’s shareholders and the preservation of existing management.

2) How it works

Finding a white knight could be beneficial to the target company in that it will create competition for the hostile bidder. First, this white knight could offer a higher price for the target so as to directly counter the hostile bidder’s original price. The hostile

⁵⁰⁵ Patrick Barwise, ‘OB or Not OB?’ (2006) 7 Business Strategy Review 49,52.

⁵⁰⁶ Tim Jenkinson and Colin Mayer, *Hostile Takeovers Defence, Attack and Corporate Governance* (McGRAW-Hill Book Company Europe 1994) 33.

⁵⁰⁷ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

bidder might then give up taking over the target company. Even if the hostile bidder did not give up its original intention, the participation of a white knight could help increase the takeover price of the target company, which will still be beneficial to the target.

Importantly, it is asserted by scholars that cooperation between the target and the white knight is essential due to the requirement of certain sensitive information being released by the target to the white knight about the potential profits to be made from the takeover/bid scenario.⁵⁰⁸ At the same time, a white knight could be concealed by the target to promote information acquisition by letting another bidder surface and pretending to be weak.⁵⁰⁹

Among 78 successfully defended takeover cases in the US between 1978 and 1984, 36 of them are attributed to the actions of white knights. Thus, there is some historical evidence that locating a White knight can be helpful and a relatively safe course of action for a target company to take.

As for the White squire, certain agreements should be signed when the friendly company acquires stock from the target company. Such an agreement will usually include restrictions on the transfer of shares or prohibition of further purchase of the

⁵⁰⁸ Michael C. Jensen and Richard S. Ruback, 'The Market For Corporate Control: The Scientific Evidence' (1983) April *Journal of Financial Economics* 5, 50.

⁵⁰⁹ Andrei Shleifer and Robert W. Vishny, 'Greenmail, White Knights, and Shareholders' Interest' (1986) 17 *The RAND Journal of Economics* 293, 294.

target's shares,⁵¹⁰ because the target company still needs to ensure that they do not end up under the White squire's control due to the transfer of a large percentage of shares.

3) Case studies

In the takeover involving Sina and Shanda, the white knight tactic was used together with the 'poison pill' tactic. Sina is a very famous global information service provider and is one of the four largest portal sites in China. It was listed on the NASDAQ in April 2000.⁵¹¹ Shanda Interactive Entertainment (Shanda) was also a Chinese top Internet company which was listed on the same market in 2004.⁵¹² Sina was the target of a hostile takeover by Shanda on the 18th February 2005, when Shanda claimed that it had acquired 19.5 per cent of Sina's stocks and was seeking to control Sina.com.⁵¹³ On 19th February 2005, Shanda made an official announcement of its intention to acquire Sina.com on the NASDAQ and submitted a 13-D form to the SEC which stated that this takeover was a strategic investment and that Shanda might possibly move forward to purchase Sina's stocks through public transaction, private deal, tender offer or exchange offer, in order to control Sina and accredit

⁵¹⁰ Stephen Kenyon-Slade, *Mergers and Takeovers in the US and UK : Law and Practice* (OUP 2004) 378, 379.

⁵¹¹ Bi Zhang, '10 Years after Sina Listed in the Market and Weibo Let It Show A New Life [Xinlang Shangshi Shinian Qifu Weibo Rang Laoshu Fa Xinya]' (*China Business News*, 23 April 2011) <<http://finance.ifeng.com/usstock/huagu/20110423/3924824.shtml>> accessed 02 August 2013.

⁵¹² Detailed information can be found on the Shanda Corporation's official website: <http://ir.shandagames.com/>.

⁵¹³ Yong Liu, 'China Business News: Seeing Overseas Takeovers from the M&A Case of Shenda v. Sina [Diyi Caijing Ribao: Cong Shengda Xinlang An Kan Haiwai Shichang Binggou]' (*Sina.com*, 7 March 2005) <<http://tech.sina.com.cn/i/2005-03-07/0332543039.shtml>> accessed 12 August 2013.

representatives on the board of directors. Failing this, Shanda indicated that it might sell part or all of its held Sina shares.⁵¹⁴

The executive board of directors pursued a number of options: firstly, Sina began negotiating with Tianqiao Chen, the director of the Shanda Corporation; secondly, the ‘poison pill’ was utilised to prevent Shanda acquiring more shares in the open market; and thirdly, Sina sought to invite Yahoo! - another large internet corporation - to invest in Sina as a white knight and help defend against the hostile bidder.⁵¹⁵

Another anti-takeover case featuring the white knight defence was that of Tung Shing Group⁵¹⁶ vs. Livzon Pharmaceutical Group Inc.⁵¹⁷ This was the first takeover case to happen in China which involved two listed companies bidding for one target listed company in the secondary stock market.⁵¹⁸ (Most of the earlier takeover cases in China involved helping a bidder find a shell company to be listed on the market, as

⁵¹⁴ Xiao Wang, ‘Poison Pill in Counter-Acquisition in US’ (2007) 2 Securities Market Herald 68, 69.

⁵¹⁵ Shaomin Yan, ‘Zhengquan Shibao: Baiyi Qishi Anzhu Xinlang, Longhu Dou dao Sanguo Zhengba [Securities Dairy: White Knight Secretly helped Sina, from Dragon and Tiger Fight to Heroes Legend]’ (2005) <<http://tech.sina.com.cn/i/2005-02-26/1148536430.shtml>> accessed 11 October 2013.

⁵¹⁶ Tung Shing Group is a hi-tech Pharmaceutical corporation with a total value of about 500 million from Xi’an and was listed in China’s market. Further information about the background of the Tung Shing Group can be found under the “Overview” section on its official website <http://www.topsun.com/> accessed 08 November 2013.

⁵¹⁷ Livzon Pharmaceutical Group Inc., founded in 1985, is a comprehensive pharmaceutical enterprise integrating development and research, production and sales. It has been listed among the Top 200 Asian SMEs by Forbes, in the Top 20 companies within the Chinese medical industry, and among the Top 20 Most Competitive Listed Medical & Pharmaceutical Companies. Further information about Livzon Pharmaceutical Group Inc. can be found under “Overview” on its official website: <http://www.livzon.com.cn/english/channels/89.html> accessed 08 November 2013.

⁵¹⁸ China Merger and Acquisition Research Centre and Hollyhigh International Capital, *China Merger and Acquisition Review: Book 4* (Tsinghua University Press 2003) 148.

the Chinese market is not as mature as the western countries' markets.⁵¹⁹) In 2002, China Everbright Group⁵²⁰ owned 518 state-owned legal person shares, equivalent to 12.72 per cent of Livzon's total capital. The Tung Shing Group acquired all of Livzon's shares held by China Everybright Group; it was clear to see that the ambition of the Tung Shing Group was to control Livzon. Since the Tung Shing Group had become a threat to Livzon's controlling shareholders, and to prevent Livzon being taken over by the Tung Shing Group, Livzon used two defensive tactics to fight against the hostile bidder: one was to adopt a 'Scorched Earth' policy; the other was to find a white knight.⁵²¹ The best choice of white knight available to Livzon at that time was Shenzhen Taitai Healthcare food Co. (Taitai).⁵²² After Taitai be a shareholder of Livzon, Taitai cooperated with Livzon's current controlling board of directors very well and successfully gained control by acquiring 19.34% per cent of Livzon's shares.⁵²³ Through this takeover activity, Taitai gained significant benefits for its future development and also helped Livzon, since, as a pharmaceutical company, Taitai was focused on health care products, it nonetheless wanted to expand

⁵¹⁹ Mingxia He, 'Presentation and Abnormal Phenomenon for the "Shell Value" of the Chinese Listed Companies ' (2004) 3 Finance Theory and Teaching 8, 10.

⁵²⁰ China Everbright Group is a state-controlled enterprise in China, and involves a number of business areas. See About China Everbright Group, <http://www.ebchina.com/ebchina/about.shtml> accessed 26 December 2013.

⁵²¹ China Merger and Acquisition Research Centre and Hollyhigh International Capital, *China Merger and Acquisition Review: Book 4* (Tsinghua University Press 2003) 148.

⁵²² Taitai was established in 1992 and has a leading position in the healthcare industry. It has changed its name Joincare Pharmaceutical Co. See its official website for more information: <http://www.joincare.com/> accessed 27 December 2013.

⁵²³ Jianmin Dai and Wen He, 'Zhu Baoguo Xi Caikong Jiankang Yuan Lizhu Si Xiangpi Tang Guanlian Jiaoyi Mimi' (*Sina Finance*, 28 July 2013).
<<http://finance.sina.com.cn/stock/s/20130729/055816268147.shtml>> accessed 26 December 2013.

its business area to the medical area - and Livzon held a key factor in this respect – the approval documents of the China Food and Drug Administration.⁵²⁴ Without these approval documents, drugs cannot be produced, even if Taitai has the ability and sufficient resources to make them. Thus, the participation of the white knight not only saved the target company, but also resulted in a win-win situation for both companies.

4) Discussion and summary

As in the case of Sina, the target company may not use only one tactic to defend against the hostile raider but rather, employ a combination of different tactics. The white knight defence is potentially useable with most other takeover defensive measures. For instance, if the target prepares to repurchase their shares with an insufficient budget, they can seek a white knight to help by tendering a certain percentage of shares or other benefits to secure the ownership of the target company.⁵²⁵

The ‘Crown Jewel’⁵²⁶ is seen as part of a “lock up” transaction, which usually occurs when a white knight is involved.⁵²⁷ The crown jewel is a key asset of the target company and is likely to be safe in the hands of a friendly “bidder” - a white knight

⁵²⁴ Ibid.

⁵²⁵ Yungeng Xie, ‘Media Takeover and Anti-takeover [Chuanmei Binggou yu Fan Binggou]’ (People.com, 7 July 2005) <<http://media.people.com.cn/GB/40628/3524651.html>> accessed 01 Aug 2013.

⁵²⁶ This is another takeover defence strategy that involves the target company selling important assets - its crown jewels- to a friendly buyer when faced with a hostile bidder. This tactic will be discussed further in the next chapter.

⁵²⁷ Tianshou Shi, *Company Law* (2nd edn edn, Peking Law Press 2006) 502 cited from Liang Huang, *A Study on the Legal Regulation of Anti-takeover of Listed Corporations* (Jilin University 2010) 60.

could therefore be a good choice. That said, the white knight is ultimately an independent corporation, and a target company's board of directors should consider the potential risk that a white knight will act objectively, not emotionally. It is also understandable that directors will act in their own company's interest, such that if a white knight defence tactic is deployed, it could have one of two results: The first, which benefits the target company by defending against the hostile bidder and benefits the white knight in that they gain a certain percentage of the target's shares or assets. The second could be that the white knight may turn to be a grey knight, and the target company cannot ultimately avoid being taken over.

Overall, however the white knight's typical benefits usually outweigh the possible risks. As per the case of Tung Shing and Livzon, the cooperation of the white knight, Taitai, successfully helped the target company resist the hostile takeover and, to a certain extent, this furthered the development of both companies and benefited both companies' shareholders. Although all defensive tactics have some pros and cons, it could be argued that white knight defence enjoys considerably less risk than other tactics and it is among the tactics not prohibited by Chinese legislation. Although there is some research that suggests the performance of a company which has acted as a white knight may not be as positive as expected after trying to save a target company,⁵²⁸ that does not mean the white knight defence is not a viable option for the

⁵²⁸ Carolyn Carroll, John M. Griffith and Patricia M. Rudolph, 'The Performance of White-Knight Management' (1998) 27 Financial Management 46,56. According to this research, white-knight managers may "make less efficient decisions than do hostile bidders", and CEOs who make big

target company in takeover defence and there are case studies which attest to the win-win situations that can be created by a cooperative target and white knight - such as Livzon and Taitai. The white knight defence tactic is also less complicated than others (such as the poison pill) because those tactics involve special shares with certain rights plan, whereas the white knight defence can be seen as relatively straightforward business cooperation between two or more companies that may also act as a defensive measure. When choosing a white knight as a business partner, what matters most is not whether the plan is successful, but whether this ally can be trusted. White knights, such as Taitai can face the problem of over-financing, because most of white knights raise capital by investing in listed companies no matter whether it saved the target company in the end or not. If the company cannot make good use of the capital raised from the stock market, the risk could only be taken by those innocent investors in the market. Thus the supervision administration and the legislators could consider that problem serious and take a decision whether to encourage those measures or not.⁵²⁹ That said, this problem is not exclusive to the white knight defence, and could happen in any business investment activity in the stock market. All mergers and acquisitions end up with certain amount of investment into the listed companies and those investors could be considered to be raising money from the stock market.

mistakes in business may be removed, even whilst inefficient management teams are relevantly safe in their positions.

⁵²⁹ China Merger and Acquisition Research Centre and Hollyhigh International Capital, *China Merger and Acquisition Review: Book 4* (Tsinghua University Press 2003) 149.

The white knight is a popular and effective takeover defence measure: It is widely used both in the US and the UK, and there are a number of successful cases where its use helped the target in the takeover battle. One thing should be noticed that to invite a white knight in the UK, there are still rules to be followed. “The directors should recommend the shareholders to accept the competing bid and would make the substance of the advice received by its independent financial adviser on the bid known to the shareholders”⁵³⁰ as it is required by the Code.⁵³¹ Moreover, the white knight strategy does not need a special legislative framework, and can work in either the western or Chinese market, so it can ultimately be seen as a user-friendly tactic with relatively low risk.

As for the White squire, its function is similar to that of the white knight and it could therefore be presumed that it would also work well in the Chinese market and be a good choice of defence strategy for a target company. But in the UK’s market, it is prohibited by the Code, because it may include material changes to the share capital and voting structure of the company, which requires the shareholders’ approval.⁵³²

4. Cross holding and ESOP

1) Definition & Features

⁵³⁰ Stephen Kenyon-Slade, *Mergers and Takeovers in the US and UK : Law and Practice* (OUP 2004) 714.

⁵³¹ The Takeover code 2013 Rule 3 and Rule 25.

⁵³² The Takeover Code 2013 Rule.21.

Cross holding means a number of companies hold each other's shares so that they link together like a mesh. Thus if a hostile takeover emerges, they can help each other to increase the target company's shares and hopefully prevent the hostile bidder controlling the target company.⁵³³ Often, the target's shares are held by its employees, so this could diffuse the ownership of the target company; this plan is called the "employee stock holding plan", or "employee stock ownership plan"(ESOP).⁵³⁴ Moreover, the employee stock holding plan can be enacted alongside other defensive measures, such as the white knight defence.

In fact, the ESOP originated from the employee benefit plan, which centred on pension plans in the US.⁵³⁵ It was regulated by Employee Retirement Income Security Act (ERISA) of 1974.⁵³⁶ According to the reports of the US General Accounting Office (GAO) in 1986, the ESOP was classified as one of four major types: leveraged, leveragable, nonleveraged, and tax credit.⁵³⁷ The leveraged ESOP is

⁵³³ Shun Luo, 'Woguo Shangshi Gongsi Fan Shougou Shizheng Fenxi Ji Falv Guizhi Yanjiu [Empirical Study over China's Listed Company's Takeover Defensive Activities and Research on Relevant Legislations]' (Master, China University of Political Science and Law 2011) 14.

⁵³⁴ M Pagano and P F Volpin, 'Managers, Workers, and Corporate Control' (2005) 60 *The Journal of Finance* 841, 843.

⁵³⁵ J.Fred Weston, J.Harold Mulherin and Mark Mitchell, *Takeovers, Restructuring, and Corporate Governance* (4th edn edn, Pearson Education Limited 2003) 379.

⁵³⁶ *Ibid* 379.

⁵³⁷ According to Weston, Mulherin and Mitchell's research, "the leveragable and nonleveraged ESOPs are also recognized under ERISA and are plans that have not used leveraging." The previous plan is authorized but not required to borrow funds while the latter one is essentially a stock bonus plan that is required to invest primarily in the securities of the employer firm. Tax credit ESOP is provided by Tax Reduction Act of 1975, and by contributing certain amount to this plan, extra percentage of credit could be earned in addition to the regular investment credit in existence at that time. In this thesis, it will only focus the leveraged ESOP as it is the one which played as a takeover defensive measure, not the other three. Further information about those three ESOPs could be found in *ibid* 380-400.

the type used as a takeover defensive plan for the target listed companies in the US⁵³⁸ which “borrows funds to purchase securities of the employer firm”; the employer firm makes contribution to the ESOP trust in an amount for both repayment of the capital and the annual interest of that loan. Data show that about 19 per cent of shares were held by employees other than the top management in 100 large high-technology firms in the US,⁵³⁹ which could explain the wide use of ESOPs.

ESOPs have also been deployed by UK listed companies, but the proportion of companies that have used the ESOP is far behind the US.⁵⁴⁰ In recent years, UK lawyers and researchers have started to pay attention to the ESOP, but the ESOP’s development in the UK is still not as mature as in the US.⁵⁴¹ Moreover, in the US, the ESOP should be with proper purpose since an ESOP “may increase its equity stake in the target company by purchasing a substantial number of the target’s voting shares with the proceeds of the recapitalization”.⁵⁴² However, in the UK, the ESOP could only be used as a pre-bid defensive tactic with proper purpose and the shareholders’

⁵³⁸ Ibid 386.

⁵³⁹ Andrew Tylecote and Paulina Ramirez, ‘Corporate Governance and Innovation: The UK Compared with the US and ‘Insider’ Economies’ (2006) 35 Research Policy 160, 168.

⁵⁴⁰ Ibid 168.

⁵⁴¹ Advocates for the employees shareholding plan were from the 2010s for example the Chancellor of the Exchequer made a speech in 2012 to advocate for the employees’ rights plan. His speech could be found on Rt Hon George Osborne, ‘Conference 2012: George Osborne’ (*Conservatives*, October 8 2012) <http://www.conservatives.com/News/Speeches/2012/10/George_Osborne_Conference_2012.aspx> accessed 02 January 2014.

⁵⁴² Stephen Kenyon-Slade, *Mergers and Takeovers in the US and UK : Law and Practice* (OUP 2004) 359.

approval because of the Code prohibit the directors to recapitalise without the shareholders' consent.⁵⁴³

In this thesis, we can observe that some defensive tactics share similarities and intersect. The intersection here is between the White squire defence and the crossholding defence. To some extent, if the crossholding defence is achieved via the help of employees, it can be seen as an "employee stock ownership plan" and in certain circumstance, the employees holding the target's shares can act as a White squire for the target company, and defend against the hostile bidder(s). By way of a reminder, per the discussion above, the White squire is a third-party from the target company and the hostile bidders, and can hold certain amount of shares to secure voting rights in the target company, with the intention of voting against the hostile bidders and secure control of the target company. Likewise, the ESOP is designed to disperse the shareholding structure in the target company by giving shares to its own employees; once the hostile bidders emerge, these employees are expected to act against the corporate raiders and protect the target company.⁵⁴⁴

2) How it works

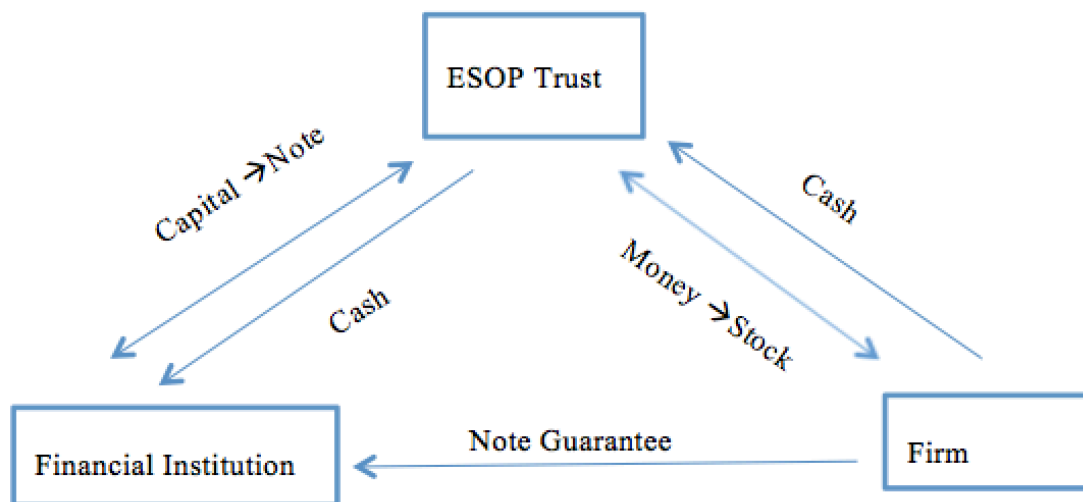
Sometimes, a target company has many subsidiaries (often more than three), and all the shares of these subsidiaries are owned by their parent company. These shares can

⁵⁴³ The Takeover Code 2013 Rule 21.

⁵⁴⁴ M Pagano and P F Volpin, 'Managers, Workers, and Corporate Control' (2005) 60 *The Journal of Finance* 841, 864. It could be almost true that the workers are allies of the target company who do not want to take the risk of losing their job.

be transferred from a parent company to a subsidiary, with the parent company transferring its most valuable assets to a subsidiary. In doing so, the parent company will no longer have a blocking shareholding.⁵⁴⁵ However, if the parent company wants to defend against the hostile bidder by using this tactic, the loyalty of these subsidiaries is a key consideration.

The application of the ESOP is illustrated in the figure below:



Per this figure,⁵⁴⁶ the ESOP Trust is set to borrow money from financial institutions by issuing promissory notes.⁵⁴⁷ The sponsoring firm should guarantee those notes.

⁵⁴⁵ Katerina S. Kokot, 'The Art of Takeover Defence' (2006) September The Ukrainian Journal of Business Law 18, 19. Available at http://www.pwc.com/en_UA/ua/assets/pwc_atd_eng.pdf, accessed 01 July 2015.

⁵⁴⁶ This figure makes reference to United States General Accounting Office, *Employee Stock Ownership Plans: Benefits and Costs of ESOP Tax Incentives for Broadening Stock Ownership* (Report to the Honorable Russell B Long, US Senate 1986) 49 Here in this chapter, it refers to the instrument in which the issuer promises in writing to pay a certain amount of money to the payee under certain terms.

⁵⁴⁷ Promissory note either substitutes for money or performs in part the functions of money. See J S Waterman, 'Promissory Note as a Substitute for Money' (1930) XIV Minnesota Law Review 313.

Then, the ESOP Trust will purchase shares from the sponsoring firm, and the firm in turn contributes cash to the ESOP Trust. Last, the ESOP Trust uses cash to repay the principal sum and interest on the loan to the financial institution.

Sometimes, if the target company is using an ESOP to increase the defence effects, this can help the target company's shareholding structure become more dispersed, and even if the employees do not hold a large percentage of shares (since "employees' lobbying against a change in control is complementary to long-term contracts as a takeover deterrent"⁵⁴⁸), the ESOP's defensive effect cannot be denied.

3) Case studies

There used to be cases in China in which a target company successfully defended against a hostile bidder by deploying the cross holding method. One such case was in 2004, between CITIC Securities⁵⁴⁹ and GF Securities,⁵⁵⁰ where CITIC Securities announced their intention to acquire GF Securities at a price of RMB 1.25 (GPB 0.13) per share in order to hold 51 per cent of GF Securities's voting shares.⁵⁵¹

⁵⁴⁸ M Pagano and P F Volpin, 'Managers, Workers, and Corporate Control' (2005) 60 *The Journal of Finance* 841, 843.

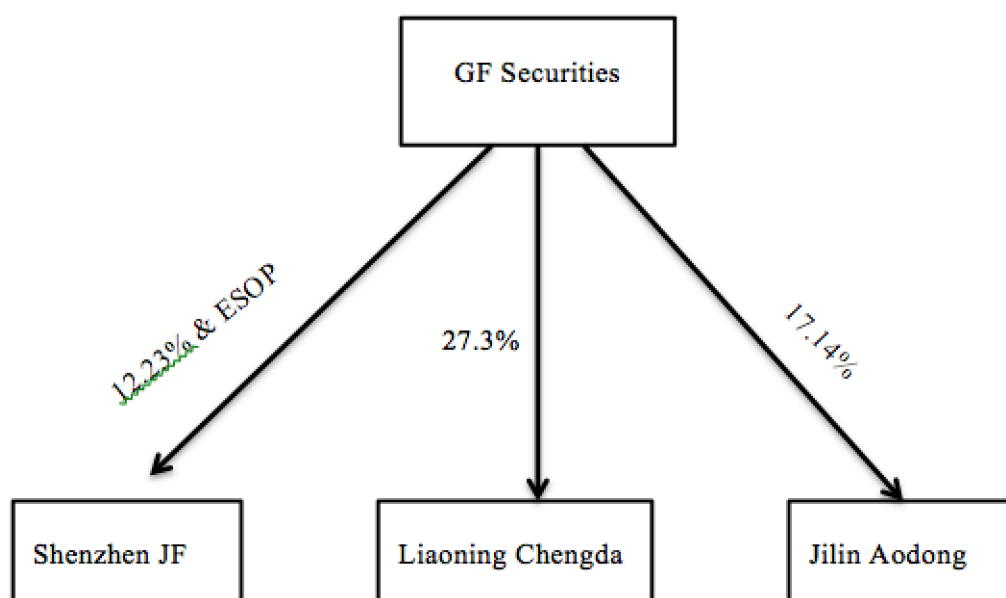
⁵⁴⁹ "CITIC Securities Company Limited ("CITIC Securities" or the "Company") was established in October 1995" and "is top-ranked in the Chinese capital markets". More information could be found on its official website: <http://www.citics.com.hk/AboutCS.aspx> accessed 24 December 2013.

⁵⁵⁰ "GF Securities as one of China's first integrated securities companies", more information could be seen on its official website: <http://www.gf.com.cn/en/company.html> accessed 24 December 2013.

⁵⁵¹ CITIC Securities, 'About CITIC Securities Acquiring Shares of GF Securities [Zhongxin Zhengquan Gufen Youxian Gongsi Guanyu Shougou Guangfa Zhengquan Gu]' (*Netease.com*, 13 October 2004) <<http://media.163.com/04/1014/20/12MAIU320014187M.html>> accessed 24 December 2012.

Shortly after the release of CITIC Securities's takeover announcement, GF Securities utilised the employee stock holding strategy to save the company. Specifically, GF Securities treated its sub-company, Shenzhen Jifu (Jifu), as an "employee" in order to transfer an amount of GF's shares to other companies: 3.83 per cent to Yunda Tech., and 8.4 per cent to Meiyuan, respectively. Thus, Jifu owned 12.23 per cent of GF's shares in total and became the fourth-largest shareholder of GF Securities. At the same time, the original third-largest shareholder, Jilin Aodong, increased the ratio of GF's shares to 27.14 per cent, and Liaoning Chengda increased its shareholding to 27.31 per cent. As a result, the total shareholding ratio was 66.68 per cent of GF's shares, which meant that CITIC Securities could not achieve its goal to control GF Securities. GF Securities also used ESOP, by letting JF's employees have GF Securities' shares to make these four companies unbreakable allies.

A cross shareholding structure is represented in the figure below:



The ESOP bonded the employees' interests and their company's interest through the shares; if the target company was taken over, the employees who had the target company's shares would be taking the risk as well.⁵⁵² Just over a month later, CITIC revoked its hostile offer for GF Securities. The employees had successfully stood together to vote against the hostile bidder in this case. So, in this case, the cross holding tactic was a success in defending against a hostile bidder.

In the US, there was a notable case where a target company successfully used the ESOP to defend against a hostile bidder and increased the popularity of ESOPs as a defensive tactic in doing so.⁵⁵³ That case concerns Shamrock Holdings'⁵⁵⁴ takeover bid for Polaroid⁵⁵⁵ in 1988. In that case, Shamrock Holdings acquired 6.9 per cent of Polaroid's shares and intended to make a tender offer for control. However, Polaroid created an ESOP whereby it purchased 14 per cent of its common shares and created a defensive term in its charter stating that any hostile acquirer could not merge with the target company for at least 3 years unless the hostile bid was supported by more than 85 per cent of shareholders in the target company.⁵⁵⁶ That is to say, it became

⁵⁵² Wenting Liu, 'Research on the Practice of Our Listed Companies' Takeover Defense Tactics [Woguo Shangshi Gongsi Fan Shougou Shijian de Falv Yanjiu]' (Masters Thesis, China University of Political Science and Law 2010) 17.

⁵⁵³ J.Fred Weston, J.Harold Mulherin and Mark Mitchell, *Takeovers, Restructuring, and Corporate Governance* (4th edn edn, Pearson Education Limited 2003) 386.

⁵⁵⁴ "Shamrock Holdings was founded by the late Roy E Disney in 1978 and serves as the investment vehicle for certain members of the Roy E Disney Family." Information retrieved from its official website, www.shamrock.com, and from ibid 386.

⁵⁵⁵ Polaroid is a famous company best known for pioneering instant photography. More information can be seen on its official website: <http://www.polaroid.com>.

⁵⁵⁶ J.Fred Weston, J.Harold Mulherin and Mark Mitchell, *Takeovers, Restructuring, and Corporate Governance* (4th edn edn, Pearson Education Limited 2003) 386.

impossible for Shamrock Holdings to control Polaroid after the creation of Polaroid's ESOP. Shortly after that, Shamrock Holdings sued Polaroid in court⁵⁵⁷ about the use of the ESOP but ultimately lost,⁵⁵⁸ because the Court of Chancery held that the ESOP adopted by Polaroid was "entirely fair", acknowledging the anti-takeover potential of the ESOP.⁵⁵⁹

4) Discussion and summary

It can be seen from these cases that cross holding can be beneficial in lowering transaction costs,⁵⁶⁰ expanding the scale of operations and lowering management risk.⁵⁶¹ Additionally, due to the complicated cross shareholding structure of the target company, it could be assumed that it could be easier for the target company to seek a white knight, because any cross holding shareholder could make a good choice of

⁵⁵⁷ *Shamrock Holdings, Inc. v Polaroid Corp* 559 A. 2d 278, 289 (Del. Ch. 1989).

⁵⁵⁸ J.Fred Weston, J.Harold Mulherin and Mark Mitchell, *Takeovers, Restructuring, and Corporate Governance* (4th edn edn, Pearson Education Limited 2003) 386.

⁵⁵⁹ In the case of *Shamrock Holdings, Inc. v Polaroid Corp* 559 A. 2d 278, 289 (Del. Ch. 1989) , it was concluded that: "The fact that the ESOP has confidential tendering provisions was a significant element in this Court's conclusion that the ESOP is fundamentally fair." And in Marc J Lane, *Representing Corporate Officers, Directors, Managers, and Trustees* (2nd edn edn, Wolters Kluwer 2010) 8-49 summaries of the conclusion can be found.

⁵⁶⁰ According to Coase's theory, "outside the firm, price movements direct production, which is coordinated through a series of exchange transactions on the market. Within a firm, these markets transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur co-ordinator, who directs production." If the activities are turning from "outside" the company into "inside" the company, certain transaction costs can be saved. Crossholding structures between companies can also be seen as inside company actions, so could further reduce the transaction cost. For more details, see Ronald Coase, "The Nature of the Firm" (1937) 4 *Economica* 386, 405.

⁵⁶¹ Shun Luo, 'Woguo Shangshi Gongsi Fan Shougou Shizheng Fenxi Ji Falv Guizhi Yanjiu [Empirical Study over China's Listed Company's Takeover Defensive Activities and Research on Relevant Legislations]' (Masters theisi, China University of Political Science and Law 2011) 24.

white knight and save the company by transferring more shares to certain shareholders. The cross holdings between a parent company and its subsidiaries are usually much safer than the cross holding of shares between a target company and a white knight, since, as discussed previously, a white knight can become a grey knight. However, it is a complicated takeover defensive measure and even if a hostile bid is attractive, the obstacle posed by such a sophisticated shareholding structure will increase the difficulty of take over. Accordingly, it will make the target company less attractive to friendly bidders.

In fact, two ways of achieving the employee shareholding plan can be identified: one is where the target company repurchases its shares for its employees, which could be classified as Share repurchase tactic and may have limitations; the other operates via the ESOP trust and the help of a third party to achieve this goal. The ESOP is not perfect, however, as there could be financing issues with the ESOP cost and there should be a limitation of the percentage of shares issued to employees. Usually, financing an ESOP is achieved with the help of a White squire, by transferring the target's shares or selling its assets,⁵⁶² and the shares are purchased by the target company and given to its employees. However, there is a clear limitation on issuing new shares to employees in China. This is regulated under China's Company Law, such that if the company wants to repurchase its shares in order to distribute them to

⁵⁶² M Pagano and P F Volpin, 'Managers, Workers, and Corporate Control' (2005) 60 *The Journal of Finance* 841, 859; Stephen Kenyon-Slade, *Mergers and Takeovers in the US and UK : Law and Practice* (OUP 2004) 378.

its employees, the amount of shares distributed to employees may not exceed 10 per cent⁵⁶³ of the total shares of the target company, or this plan will be blocked by the securities supervision department.⁵⁶⁴ Moreover, it is totally prohibited by law to repurchase shares of any company without the support of the shareholders, even if it is for the purpose of encouraging employees to give those shares to them.⁵⁶⁵ This regulation is understandable given concerns regarding reduction in the company's capital to finance this employee shareholding plan. Prior to this regulation of ESOP, this made a post-bid ESOP relatively impossible to adopt as a takeover defensive measure in China. That is to say, once the hostile bid was placed, it was better to consider other takeover defensive measures.

In addition, in China, there are more limitations on delivering shares of state-controlled companies to employees because of these companies' special shareholding characters. If these companies wish to deploy an ESOP to deter hostile bidders, it must have the permission of the relevant state-owned assets supervision and admissions department.⁵⁶⁶

⁵⁶³ Administrative Measures of the Listed Companies' Employee Shareholding Plan (Exposure Drafts), available at <https://www.google.co.uk/webhp?sourceid=chrome-instant&ion=1&espv=2&ie=UTF-8#>, accessed 1 April 2016.

⁵⁶⁴ Wenting Liu, 'Research on the Practice of Our Listed Companies' Takeover Defense Tactics [Woguo Shangshi Gongsi Fan Shougou Shijian de Falv Yanjiu]' (Masters Thesis, China University of Political Science and Law 2010) 21.

⁵⁶⁵ Company Law of the People's Republic of China (2005 Revision) a. 143.

⁵⁶⁶ This is also part of work included in the Working Plan of SASAC of State Council to Guide Local SASAC in 2015 [Guo Wu Yuan Guo Zi Wei 2015 Niandu Zhidao Jiandu Difang Guozi Gongzuo Jihua], May 2015, available at <http://www.sasac.gov.cn/n85881/n85911/c1908341/content.html>, accessed 12 July 2015.

However, things seem to have changed in recent years, just as the public attitude toward ESOP is changing in the UK. China has experienced the development of more American-style ESOP regulation over the past two years. As discussed, if the employee shareholding plan succeeds, regarding the repurchase of shares by the target company, there are certain limitations and financial burdens. However, a western-style ESOP could be user-friendlier and is, in fact, already in use in some Chinese listed companies but just lacks systematic legislation. Thus, the launch of the draft of the Interim Measures on the Administration of ESOP of Listed Companies⁵⁶⁷ (hereafter, “Interim Measures”) in August 2012 could be taken as a sign confirming the takeover defence effects of the ESOP in China, even though this draft is still under discussion and it is hard to tell when it may take effect officially. Admittedly, the draft of these Interim Measures does not cover takeover defence effects and focuses more on the principles of using the ESOP, the business benefits of the ESOP (for example, how an ESOP could encourage work efficiency and initiative of employees), and regulates some details regarding its use.⁵⁶⁸ The anti-takeover effect of an ESOP is manifest; it seems likely that one day, the ESOP will work in the Chinese market. Consequently, the section below will focus on some regulations in the Interim Measures that relate to ESOP takeover effects.

⁵⁶⁷ The sketch could be downloaded from the CSRC’s official website <http://www.csrc.gov.cn> accessed 12 December 2013.

⁵⁶⁸ CSRC, ‘Introduction of Drafting the Interim Measures on the Administration of ESOP of Listed Companies’ (CSRC, 2012) <<http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201208/P020120805589752343115.doc>> accessed 22 December 2013.

First, there is a limit of 10 per cent of the total shares that can be sold under the ESOP, and cannot be exceeded. This will not include any initial shares held by employees before the listed company's initial public offering.⁵⁶⁹ Thus, supposing the company had used the share repurchase defence successfully, it could be presumed that the total shares held by employees could amount to 15 per cent of the total shares of the target company, together with the repurchased shares by the target company. Thus, the shareholding structure of the target company could be seen as a relatively dispersed one, and that amount of shares could be helpful defending against a hostile bidder. With Polaroid, the total amount of shares held under the ESOP was 14 per cent, and was of great help to the target company in winning the hostile takeover battle.

Secondly, these may only be purchased through a third party in a secondary market; it is not for the target company itself to repurchase them.⁵⁷⁰ This entails the financial institution holding these shares not the employees themselves. Distinct from the 5 per cent of shares regulated by Chinese Company Law that may be repurchased for the employees, 5 per cent of shares must be repurchased by the target company, and the 10 per cent of shares mentioned in the Interim Measures may only be purchased by the third party: the capital management company. Of course, the money used to

⁵⁶⁹ CSRC, 'The Interim Measures on the Administration of ESOP of Listed Companies (Sketch)'

(CSRC, 2012)

<<http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201208/P020120805589752345819.doc>> accessed 22 December 2012 a.10.

⁵⁷⁰ Ibid a.15 According to the Interim Measures, five kinds of financial institutions are allowed to manage the ESOP and those are: 1. Trust companies; 2. Insurance asset management companies; 3. Securities companies; 4. Fund management companies; 5. Other qualified capital management institutions.

purchase these shares for the ESOP is funded from employees' payments based on employees' voluntary joining of this plan.⁵⁷¹ As was said by the press secretary of the CSRC, the successful implementation of an ESOP still needs the support of a profound tax preference, credit policy and other relevant regulations in related areas: The Interim Measures are still under discussion, and lessons from the western markets are welcomed.⁵⁷²

The ESOP's benefits are recognized by both the western and Chinese markets. This is likely because the use of an ESOP could work in any market, unlike other measures, and has gained public awareness both in the UK and China. An ESOP could work in a market by dispersing shareholding structures, such as it has done in the US, gaining the recognition of the Court of its anti-takeover effects, and it can also work in a market with a highly-concentrated shareholding structure, such as China's, to help the shareholding structure becoming more dispersed. It should be noticed that the application of ESOP might have negative effect on the white knight defence, but it would not totally deter the white knight because of the shareholding limit of ESOP is 10 per cent in China.⁵⁷³ It is still possible for the white knight to take control of the

⁵⁷¹ CSRC, 'Introduction of Drafting the Interim Measures on the Administration of ESOP of Listed Companies' (CSRC, 2012)

<<http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201208/P020120805589752343115.doc> >

accessed 22 December 2013 part 3.

⁵⁷² Zhuang Jia, 'CSRC: Working on the Research of Suggestions of the ESOP' (*Security Times*, 11 January 2014) <http://epaper.stcn.com/paper/zqsb/html/epaper/index/content_535718.htm> accessed 12 January 2014.

⁵⁷³ Administrative Measures of the Listed Companies' Employee Shareholding Plan (Exposure Drafts), available at <https://www.google.co.uk/webhp?sourceid=chrome-instant&ion=1&espv=2&ie=UTF-8#>, accessed 1 April 2016.

target company. However, with the help of ESOP, it will be easier for the target company to invite a white squire to act in consent to defend against a hostile bidder. Thus, an ESOP could be a win-win choice for listed companies.

5. Summary

Research shows that domestic bidders appear to be more in favour of hostile takeovers than foreign acquirers. Easterbrook and Jarrell supported this idea and found that managers who adopted takeover defensive tactics “do a grave disservice to their investors” because even if they lower the risk, of the target’s shares being in the market, it is still possible that there will a loss in shareholders’ equity.⁵⁷⁴ Thus, managers are highly likely to defend against any offer to secure their place in the target company at the expense of the shareholders’ interests. However, the possible abuse of these measures could not be the reason for prohibiting them. For example, an ESOP could be a good plan for the listed companies to achieve both motivation of employees and anti-takeover effects.

In fact, all four kinds of defence tactic discussed were related to the trade of shares in the stock market. And all four measures could work in any kind of market: the western-style dispersed one or the Chinese-style continuously evolving market. Additionally, these tactics could work in any legislative system with only small differences, because these measures do not require a certain level of market

⁵⁷⁴ Frank H Easterbrook and Gregg A Jarrell, ‘Do Targets Gain From Defeating Tender Offers?’ (1984) 59 NYUL Rev 277, 292.

development to work. The only reason that certain markets have prohibited certain defensive measures is when the tactic or issues relating to it are high-risk.

Specifically: (1) the Share repurchase tactic is regulated very strictly and certain measures are prohibited because of the risk of unfair treatment of shareholders, as in the case of greenmail. This thesis does not recommend the use of share repurchase in China, except for what is allowed by Article 143 of China's Company Law,⁵⁷⁵ because the use of share repurchase carries a high risk of reducing the target company's total capital and may harm shareholders' interests. (2) The Pac-man defence is also a high-risk tactic, since it could raise the financial burden of the target company, and even the hostile bidder would not benefit from a takeover. However, it does have the potential to allow the target company to retain control. The economic returns in the future are not assured if the target company survives, however. Thus, this defence tactic is not guaranteed to help the development of China's stock market, but should not be banned totally. (3) Both the white knight and ESOP can be very user-friendly and effective measures to defend against hostile bidders and carry lower risks, which could be valued by regulators. The cross holding tactic is more complicated, but could even be a more effective one because the more complicated the shareholding structure is, the less possible it is that a hostile bidder will emerge.

⁵⁷⁵ Company Law of the People's Republic of China (2005 Revision) Article 143: A company shall not purchase its own shares, except where: (1) It reduces its registered capital; (2) It merges with another company that holds its shares; (3) It rewards the staff and workers of the company with its shares; or (4) A shareholder requests the company to purchase his shares because he holds objections to the resolution on the merger or division of the company adopted by the shareholders general assembly.

Chapter 5: Takeover defence tactics relating to management

Executive summary

This chapter will discuss takeover defensive measures relating to management including the poison pill, scorched earth policy, shark repellents, dual class recapitalisation and three kinds of parachute measures. These tactics can be employed pre- or post-hostile offer and relate to the management team of a company.

The ‘poison pill’ is the most well known of these tactics, and is still used in the US, but not in the UK market. A review of the creation and use of the poison pill and related cases concludes that the poison pill is a powerful strategy to stop a hostile raider by increasing takeover costs. Research has shown that this tactic works well in the mature American market (it remains an effective method to protect the control power of the listed company), and has been legalised in China’s market as from 2014.

A review of the ‘scorched earth’ policy, used in some takeover cases, concludes that it is an internecine method and not good for the long-term interests of target companies and should therefore be used carefully. In addition, because of the internecine feature of this method, it is not legal in China’s market; it does not fit China’s Company Law principle to protect the best interest of shareholders.

A review of the use of the dual class recapitalisation tactic finds that high-tech companies prefer this tactic in the US but few use it in China. This is also a tactic that gives different voting rights to different class of shares (relative to the poison pill tactic) to ensure the company is controlled by a certain class of shareholders. This tactic could be effective in China in the future, following the adoption of preferred shares, but will encounter similar issues as per the poison pill tactic.

Finally, this chapter discusses three kinds of parachute tactics that largely focus on giving high compensation for managers to increase the cost of hostile takeovers. These tactics are user-friendly ones and can fit any market and any legal system. This tactic is legalised in China and could be a good choice for targeted companies.

1. Introduction

We have seen that each takeover market has different structures and other characteristics. We now consider, in the next three chapters, the way in which several further defence tactics have evolved and assess their suitability to each market setting.

There are many kinds of takeover defence tactics, and these can be categorized in different ways. Some classify these measures into two groups: proactive defence measures and reactive defence measures. In this thesis, all measures will be classified into three groups: takeover defence tactics, relating to stock trading; takeover defence tactics relating to management; and tactics relating to litigation. (Some of the measures may also involve activities that fit into other groups - for example, the

poison pill is categorized under takeover defence tactics relating to management, but once triggered, may also involve some activities regarding stock trading. This will be noted where applicable.)

2. Poison Pill

1) Definition & Features

A poison pill is a kind of “rights plan”.⁵⁷⁶ It is one of the most frequently used antitakeover measures in the US, and was previously called a “warrant dividend plan”.⁵⁷⁷ Martin Lipton first mentioned it to argue for the directors’ duties of deciding whether to accept a takeover offer in 1979⁵⁷⁸ and in 1982, he created this popular defensive tactic.⁵⁷⁹ The pill received the support of the Delaware Court in 1985 in the case of *Moran v. Household International, Inc.*⁵⁸⁰ More recently, in 2010, Airgas Inc.,⁵⁸¹ J.C. Penney Co.,⁵⁸² and Barnes & Noble Inc.⁵⁸³ all adopted poison pills

⁵⁷⁶ Krishnan Chittur, ‘Wall Street's Teddy Bear: The "Poison Pill" as a Takeover Defense’ (1985) 11 J Corp L 25, 38.

⁵⁷⁷ Erik Yang and Samim Zarin, *Mergers & Acquisitions - Hostile Takeovers and Defense Strategies Against Them* (University of Gothenburg 2011) 16.

⁵⁷⁸ Martin Lipton, ‘Takeover Bids in the Target's Boardroom’ (1979) 35 The Business Lawyer 101,134.

⁵⁷⁹ Shira Ovide, ‘Marty Lipton: Why I Invented the Poison Pill’ *The Wall Street Journal*, (December 29, 2010) <<http://blogs.wsj.com/deals/2010/12/29/marty-lipton-why-i-invented-the-poison-pill/>> accessed 10 August 2013.

⁵⁸⁰ Dosoung Choi, Sreenivas Kamma and Joseph Weintrop, ‘The Delaware Courts, Poison Pills, and Shareholder Wealth’ (1989) 5 J L Econ & Org 375, 376.

⁵⁸¹ Steven M. Davidoff, ‘Winners and Losers in the Airgas Poison Pill Case’ *The New York Times*, (16 February 2011) <<http://dealbook.nytimes.com/2011/02/16/who-won-in-the-airgas-poison-pill-case/>> accessed 01 August 2013.

⁵⁸² Shira Ovide, ‘Marty Lipton: Why I Invented the Poison Pill’ *The Wall Street Journal*, (December 29, 2010) <<http://blogs.wsj.com/deals/2010/12/29/marty-lipton-why-i-invented-the-poison-pill/>>

when they were facing hostile takeover bids. Also, evidence shows that a company with a poison pill is still likely to continue as a target and may finally be acquired by some bidder even if it survived some hostile takeover attempts.⁵⁸⁴

A poison pill is triggered by certain conditions, such as a pre-specified percentage of shares bought by the hostile bidder. It gives the target's shareholders certain rights. The aim is to "transfer wealth and/or control from the acquiring firm to the target firm and so provides a means of alleviating takeover risk".⁵⁸⁵ It has been popular in the US since it was invented and has attracted both supporters and critics - it has received a favourable consideration by American courts,⁵⁸⁶ but does not require shareholders' approval for its use. Indeed, according to Jenkinson and Mayer, approximately 560 companies employed poison pills from 1985⁵⁸⁷ to 1988 and some of them are examples where management "clearly act[ed] against shareholder interests".⁵⁸⁸

accessed 10 August 2013 and all the news about the takeover activities could be seen on Wallstreet Journal and New York Times. See: Rachel Dodes and Joann S. Lublin, 'J.C. Penney, Facing Activist Efforts, Adopts 'Poison Pill' *The Wallstreet Journal* (18 October 2010) <<http://online.wsj.com/article/SB10001424052702304410504575559931192338068.html>> accessed 05 August 2013.

⁵⁸³ Dealbook, 'Barnes & Noble Shareholders Back Poison Pill' *The New York Times*, (17 November 2010) <http://dealbook.nytimes.com/2010/11/17/barnes-noble-shareholders-back-poison-pill/?_r=0> accessed 01 August 2013.

⁵⁸⁴ Elizabeth A. Raymond and Stuart M. Litwin, 'Mergers and Acquisitions in the United States: Review of Defensive Charter and By Law Provisions for Delaware Incorporated Companies' (1996) 7 ICCLR 104, 107.

⁵⁸⁵ Richard D. MacMinn and Douglas O. Cook, 'An Anatomy of the Poison Pill' (1991) 12 Managerial and Decision Economics (Special Issue: Corporate Structure and Control) 481. 481.

⁵⁸⁶ Ibid 481.

⁵⁸⁷ Tim Jenkinson and Colin Mayer, *Hostile Takeovers Defence, Attack and Corporate Governance* (McGRAW-Hill Book Company Europe 1994) 33.

⁵⁸⁸ Ibid 25.

In the UK, the poison pill does not function in the same way as in the US. It could instead be described as a form of “golden parachute”, since it provides certain options to existing management.⁵⁸⁹ Consistently with the discussion in the second chapter, the UK’s takeover legislation is shareholder-friendly, the use of poison pills is precluded in UK takeovers because Rule 21 of Takeover Code set the requirement of shareholders approval.⁵⁹⁰ In addition, because of the invention and legality of the poison pill in the US, this section, will discuss its features and rationales mainly from an American perspective.

As a takeover defence, a poison pill may have different variants. The most frequently used are the flip-over poison pill and flip-in poison pill.⁵⁹¹ The flip-over poison pill functions by transferring some control from the bidder company to the target’s existing shareholders by allowing the target’s shareholders to purchase shares of the bidder company at a much lower price than available on the general the market. This is particularly efficacious when the bidder aims to acquire all of a target’s shares.⁵⁹² The flip-in poison pill is a proactive measure, which allows the target company to issue preferred shares for existing shareholders once a hostile bidder emerged; it is

⁵⁸⁹ Ibid 33.

⁵⁹⁰ The Takeover Code Rule 21.

⁵⁹¹ Richard D. MacMinn and Douglas O. Cook, ‘An Anatomy of the Poison Pill’ (1991) 12 *Managerial and Decision Economics* (Special Issue: Corporate Structure and Control) 481, 481.

⁵⁹² Ibid 481.

argued by scholars to be more effective in defending against hostile bids and/or increasing the tender price.⁵⁹³

The poison pill has evolved since it was invented more than 30 years ago and it has seen two ‘generations’. The first generation of poison pill was the Lenox poison pill,⁵⁹⁴ as per that triggered by Brown-Forman Distilleries Corporation announcing “a cash tender offer for ‘any and all’⁵⁹⁵ common shares of Lenox”,⁵⁹⁶ which gave preferred shareholders in Lenox the right to convert their preferred shares into common shares at a 1:40 conversion ratio. The pill also included the requirement of super-majority approval if anyone wished to amend Lenox’s charter, securing the safety of the poison pill. The takeover was, ultimately, successful – and in a relatively short time - because the cash offer was attractive to Lenox’s shareholders. This highlighted some of the features and weakness of the first generation of poison pills: firstly, Brown-Forman’s offer was an “any and all” offer to all shareholders in Lenox Company. Unlike a “partial offer”⁵⁹⁷ or “two-tier offer”,⁵⁹⁸ an “any and all offer”

⁵⁹³ Ibid 481-487.

⁵⁹⁴ Krishnan Chittur, ‘Wall Street's Teddy Bear: The "Poison Pill" as a Takeover Defense’ (1985) 11 J Corp L 25, 27.

⁵⁹⁵ “Any and all” tender offer means that the acquirer will acquire any and all the shares of the target company, and it often shows the intention of the acquirer to get the control of the target company. For details, see Lloyd R. Cohen, ‘Why Tender Offers? The Efficient Market Hypothesis, the Supply of Stock, and Signaling’ (1990) 19 The Journal of Legal Studies 136.

⁵⁹⁶ Krishnan Chittur, ‘Wall Street's Teddy Bear: The "Poison Pill" as a Takeover Defense’ (1985) 11 J Corp L 25, 28.

⁵⁹⁷ Partial offer is an offer made by the bidder to acquire certain amount of shares, and it could be part of the hostile takeovers. See Patrick A. Gaughan, *Mergers, Acquisitions, and Corporate Restructurings* (5th edn, John Wiley & Sons 2010), 256.

⁵⁹⁸ A two-tier offer means that the bidder offers to buy certain amount of shares to gain control of the target company and then offers to buy the remaining shares at a lower price. See *ibid* 256, 257.

does not infringe minority shareholders' rights and treats all shareholders equally. Thus, an "any and all offer" is not easy to defend against.⁵⁹⁹ In other words, preferred shareholders could not resist the premium being offered by the bidder, and the success of the poison pill was overly dependent on the removal of target shareholders' incentive to tender their shares. Clearly, the first generation of poison pill could not achieve its goal of when the bidder offered the target an "any and all tender offer". The second generation of the poison pill was (is) the Bell & Howell's pill.⁶⁰⁰ It made some improvements over the Lenox pill by giving preferred shares voting rights and allowing redemption of what had been 3 USD shares for 300 USD, plus unpaid dividends after more than 15 years of its issuance in 1998.⁶⁰¹ Once this poison pill is triggered, preferred shareholders have the ability to redeem their shares prior to common share shareholders, which means common shareholders will get nothing if the preferred shareholder cannot or do not redeem their rights. Even if preferred shareholders do not redeem their shares, they still have the right to elect two directors to the board.⁶⁰² Compared with the first generation of the poison pill, the Bell & Howell pill made an important improvement in attracting shareholders with a high return.

⁵⁹⁹ Ibid 259.

⁶⁰⁰ Krishnan Chittur, 'Wall Street's Teddy Bear: The "Poison Pill" as a Takeover Defense' (1985) 11 J Corp L 25, 31-33.

⁶⁰¹ Ibid 31.

⁶⁰² Ibid 32.

Nowadays, the poison pill is not only used as per the previous role in defending against hostile takeovers, but is also used as a very popular tax management tool “to protect [a] company’s net operating losses”.⁶⁰³

2) How it works

It is essential to explain how the poison pill works towards achieving the goal of defending against a hostile bid. The poison pill is argued to be effective in diluting the bidder’s control of the company or making the target less attractive to the bidders.

If a target company’s shares are 10 GBP per share and there are 1 million shares listed in the market, the value of the company is 10 million GBP. The company can issue 50,000 preferred shares with the poison pill; if the bidder would like to buy the shares at 12 GBP per share,⁶⁰⁴ and wants to control the target company by acquiring 51% of shares of the target company, the total budget of the bidder would need to be 6.12 million GBP ($12 \times 51\% \times 1,000,000$). If the conversion ratio between the preferred shares and the common shares is 1:20, then after the poison pill is triggered, all the preferred shares could be converted into common shares, so the total number of the common shares of the company would then be 2,000,000 ($1,000,000 + 50,000 \times 20$). Once the poison pill is triggered, the total value is presumed to be the same as it used

⁶⁰³ Jacopo Crivellaro and Milosz Morgut, ‘The End of Nocuous Relations? New Shareholders, Poison Pills and Markets for Corporate Control’ (2012) 3 IBLJ 349, 352.

⁶⁰⁴ This means a 20% premium for the target’s shares.

to be before the hostile takeover arose.⁶⁰⁵ Consequently, every common share will be worth 5 GBP (10,000,000 / 2,000,000), and every preferred share will be worth 100 GBP (5*20) per share. Thus, if a bidder wanted to control the target company by acquiring 51% of target shares, he could acquire 51% of the target's common shares and 51% of the target's preferred shares. However, it is worth noting that 1) shareholders have the right to ask for the redemption of shares at any time following a certain point after the acquisition date or the post-merger corporation issued these shareholders equivalent securities;⁶⁰⁶ 2) the bidder should also acquire the target's shares at a premium not lower than the original tender offer provides, which means the premium should be equal or over 20% in this case. Thus, after a bidder gets control of a target company, it still needs to be able to fund the rest of the preferred shares and that potentially makes the deal very expensive.

Alternatively, a bidder could acquire less than 5% of the voting class of shares "without fil[ing] the Schedule 13-D disclosure form under Securities Exchange Act",⁶⁰⁷ and then make a tender offer for another 75% of preferred shares to have

⁶⁰⁵ It could be argued that the value of the shares may increase in the stock market and, per previous discussion, it could also be suggested that a hostile takeover could increase the price of shares of the target company. Moreover, the target could also be devalued before a hostile takeover. However, the percentage of the increased price of shares may not be predicted correctly. In respect of how the poison pill works, it is presumed that the total value of the target will stay the same.

⁶⁰⁶ Krishnan Chittur, 'Wall Street's Teddy Bear: The "Poison Pill" as a Takeover Defense' (1985) 11 J Corp L 25, 31.

⁶⁰⁷ "Schedule 13-D is commonly referred to as a "beneficial ownership report." The term "beneficial owner" is defined under SEC rules... When a person or group of persons acquires beneficial ownership of more than 5% of a voting class of a company's equity securities registered under Section 12 of the Securities Exchange Act of 1934, they are required to file a Schedule 13D with the SEC." Available at

approximately 80% preferred shares total. By gaining these shares, the bidder can gain the power to ask for a change of the target's charter and then try to remove the pill.

In relation to the functionality of the poison pill for tax purposes, net operating losses allow a company to decrease its payable taxes in the future or refund its paid taxes if it reported net losses.⁶⁰⁸ Net operating losses could be used to offset the previous two years' income and could be carried forward for up to 20 years as well.⁶⁰⁹ However, the Internal Revenue Code limits the ability to use net operating losses "after a change of ownership";⁶¹⁰ to be specific, if there is a ownership change involving a 5-percent shareholder or any equity structure shift, the loss-making company could not employ net operating losses to claim a tax refund.⁶¹¹ Thus companies can use a poison pill to prevent ownership change by setting it at a 4.99 per cent trigger.⁶¹²

US Securities and Exchange Commission's official website <http://www.sec.gov/answers/sched13.htm> accessed 12 December 2014.

⁶⁰⁸ Donald M. DePamphilis, *Mergers, Acquisitions, and Other Restructuring Activities* (4th edn, Elsevier Inc. 2008) 494.

⁶⁰⁹ J.K. Lasser, *J.K. Lasser's Your Income Tax 2011: For Preparing Your 2010 Tax Return* (John Wiley & Sons 2010) 648.

⁶¹⁰ Jacopo Crivellaro and Milosz Morgut, 'The End of Nocuous Relations? New Shareholders, Poison Pills and Markets for Corporate Control' (2012) 3 IBLJ 349, 352.

⁶¹¹ Details about this regulation can be found in the Internal Revenue Code s.382 (g) Limitation on net operating loss carry forwards and certain built-in losses following ownership change.

⁶¹² Jacopo Crivellaro and Milosz Morgut, 'The End of Nocuous Relations? New Shareholders, Poison Pills and Markets for Corporate Control' (2012) 3 IBLJ 349, 352.

A poison pill is often compared with a staggered board, which means once there is a successful takeover of the target company there could be certain directors “remain[ing] in place ... to protect the rights of the remaining minority”.⁶¹³

3) Case study

As mentioned in previous chapters, most well-known Chinese corporations are listed in the US. This chapter will study the takeover case of *Sina v. Shanda* in 2005 to illustrate how poison pills work in the US and their pros and cons.

As mentioned in Chapter 4 in the discussion of the white knight tactic, in the takeover battle between Sina and Shanda, Sina hired Morgan Stanley as its consultant⁶¹⁴ with the help of whom they issued a poison pill that aimed at diluting Shanda’s acquired rights.⁶¹⁵ This poison pill included a right for any individual, who acquired more than 10 per cent of Sina’s shares in the market, or Shanda successfully acquired more than 20 per cent of Sina’s shares, every original Sina shareholder would be entitled to buy Sina’s shares at half price.⁶¹⁶ There was a limit on buying shares – 150 USD per right – which means the poison pill right (which was enshrined in the original common shares before the poison pill was triggered) could allow the shareholder to buy no

⁶¹³ Allan M. Chapin, ‘Takeover Defenses in the United States’ (1988) 3 IBLJ 323, 325.

⁶¹⁴ Xiao Wang, ‘Poison Pill in Counter-Acquisition in US’ (2007) 2 Securities Market Herald 68, 68.

⁶¹⁵ Marina Martynova and Luc Renneboog, ‘Takeover Waves: Triggers, Performance and Motives’ TILEC Discussion Paper DP 2005-029 <<http://arno.uvt.nl/show.cgi?fid=53839>> accessed 13 August 2013 12.

⁶¹⁶ Haitao Fan, ‘Defend Shanda, Sina Use the Poison Pill [Fanji Shengda Xinlang Qidong Duwan Jihua]’ (*YNET.com*, 23 February 2005) <http://news.xinhuanet.com/fortune/2005-02/23/content_2606919.htm> accessed 14 August 2013.

more than 150 USD shares at half price.⁶¹⁷ This right could not be traded separately. At that time, Shanda had already gained 19.5 per cent of Sina's shares, which meant that the poison pill would be triggered if Shanda acquired 0.5 per cent more of Sina's shares. Then, Sina's shares were priced at 32 USD. If we assume the share price would stay constant,⁶¹⁸ the original Sina shareholders could buy 9.375(150/160) shares at 16 USD per share. The total equity of Sina was 5,048 million shares, and there were 4,064 million shares entitled with the poison pill rights excluding Shanda's 984 (5048 * 19.5%) million shares. Thus, once the poison pill was triggered, the total equity of Sina became 43148 million shares (4064*9.375+4064+984). At the same time, Shanda's acquired shares would reduce from 19.5 per cent to 2.28 per cent.⁶¹⁹ Consequently, the poison pill would clearly dilute the control power of the bidder to the target and even if Shanda continued the hostile takeover, the budget for acquiring it would be vastly higher than before.

After Sina announced the poison pill, its share price was not hugely affected⁶²⁰ and until 7 March 2005, the stock price of Sina was still 40 per cent more than the share price of Shanda.⁶²¹ This takeover activity was the first anti-takeover case between

⁶¹⁷ Mingyu Li, Chaohui Yuan and Lei Xu, 'Offence and Defence between Shanda and Sina [Shengda Xinlang Gong Fang Shu]' (*Security Market Weekly*, 13 March 2005)

<<http://tech.sina.com.cn/d/2005-03-13/1450548629.shtml>> accessed 15 August 2013.

⁶¹⁸ Once a poison pill is triggered, the share price may change in the stock market. To illustrate this case better, we presume the price is fixed, as the poison pill was not triggered.

⁶¹⁹ Mingyu Li, Chaohui Yuan and Lei Xu, 'Offence and Defence between Shanda and Sina [Shengda Xinlang Gong Fang Shu]' (*Security Market Weekly*, 13 March 2005)

<<http://tech.sina.com.cn/d/2005-03-13/1450548629.shtml>> accessed 15 August 2013.

⁶²⁰ Ibid.

⁶²¹ Xiao Wang, 'Poison Pill in Counter-Acquisition in US' (2007) 2 *Securities Market Herald* 68, 69.

two Chinese companies listed in the US market,⁶²² and it is said that “both the aggressive bidding strategy and the target firm opposition to the bid” in the case of Sina against Shanda were unprecedented in Chinese industry.⁶²³

There are some additional antidotes used by another Chinese company – Fosun Capital.⁶²⁴ In 2009, the chairman of Fosun Capital intended to become a major shareholder in Sina but he learned the lessons from Shanda’s failure. Instead of acquiring Sina’s shares, he decided to acquire one of the companies –Focus Media - that Sina was taking over in order to indirectly acquire a position in Sina’s boardroom. More importantly, at that time, the poison pill of Sina reduced the percentage of shareholdings from 20% to 10%. After Sina took over Focus Media in December 2004, Fosun has already acquired 28.65 per cent of Focus’s total shares, which meant that Fosun had 13.07 per cent of Sina’s shares after the acquisition and the poison pill was never triggered.⁶²⁵

Another case of note is the takeover offer between APTECH and Sohu. At first, Sohu welcomed APTECH’s investment into Sohu but shortly after this, Sohu found out

⁶²² Ibid 69.

⁶²³ Marina Martynova and Luc Renneboog, ‘Takeover Waves: Triggers, Performance and Motives’ TILEC Discussion Paper DP 2005-029 12 <<http://arno.uvt.nl/show.cgi?fid=53839>> accessed 13 August 2013.

⁶²⁴ This is one of the most famous corporations in China, and is engaged in investment, insurance, capital management and industry operations. For more details, see the official website: <http://www.fosun.com/> accessed 13 August 2013.

⁶²⁵ Xuefeng Zhou, ‘Guo Guangchang Qiao Po Xinlang Duwan Jihua’ (*Sohu.com*, 4 April 2009) <<http://it.sohu.com/20090401/n263139844.shtml>> accessed 19 August 2013.

APTECH's real intention, and issued a poison pill on 19 July 2001.⁶²⁶ That poison pill included a right for Sohu to issue preferred shares which entitled the shareholders of Sohu to buy a unit of Sohu's preferred shares at 100 USD per unit; if any individual or institution acquired more than 20 per cent of Sohu's shares, the preferred shares could be changed into twice of the new corporation's shares – which meant that the previous 100 USD share could be exchanged into 200 USD shares in the new corporation. Thus poison pill can therefore be seen as a combination of a “flip-in” and “flip-over” pill that would increase the budget of the bidder to buy the target shares and dilute the control rights that the bidder already had. Consequently, APTECH decided to give up taking over Sohu and the poison pill saved Sohu.⁶²⁷

4) Summary

To summarize, the poison pill functions by increasing a target company's negotiation power in making a deal “more difficult and more expensive to acquire full control”,⁶²⁸ providing the board with some time “to develop a merger strategy or find a better partner (a white knight) in times of extreme market pressure”.⁶²⁹

⁶²⁶ Shuo Wang and Qing Guan, ‘Sohu and APTECH, Poison Pill’ (*Caijing Magazine*, 26 November 2001) <<http://tech.sina.com.cn/i/2005-02-23/0116532418.shtml>> accessed 18 August 2013.

⁶²⁷ Ibid.

⁶²⁸ Allan M. Chapin, ‘Takeover Defenses in the United States’ (1988) 3 IBLJ 323, 327.

⁶²⁹ Jacopo Crivellaro and Milosz Morgut, ‘The End of Nocuous Relations? New Shareholders, Poison Pills and Markets for Corporate Control’ (2012) 3 IBLJ 349, 350.

However, whilst the poison pill has been played as the preferred corporate defence for publicly listed companies for many years,⁶³⁰ their adoption has decreased in recent times. According to Bernd Delahaye, the rate of poison pill adoption decreased from 61 per cent to 41 per cent among the top 1,500 listed companies in the United States between 2001 and 2007.⁶³¹ More importantly, the emergence of new corporate actors such as the proxy advisory firm,⁶³² shareholder activists,⁶³³ and hedge funds,⁶³⁴ etc., changed the market playing rules. The increased number of institutional investors, moreover, is “at the core of poison pill reform”⁶³⁵ because most institutional investors are seeking their own directorship over the company. The changing character of the target shareholders has prompted the decrease of poison pills because most institutional investors and new market players do not like them.⁶³⁶

Furthermore, scholars also argue that the benefits of adopting a poison pill may not be realised in terms of successfully defending against a hostile takeover but has still

⁶³⁰ Ibid 351.

⁶³¹ Bernd Delahaye, ‘Still Alive: Poison Pills and Staggered Boards as Hostile Takeover Defences - the Battle for Airgas’ (2012) 23 ICCLR 211, 219.

⁶³² A proxy advisor firm can use their professional knowledge to help their clients evaluate corporate governance issues, providing related consulting services, and may influence shareholders’ decisions over board elections or other issues. See Eric Yocam and Annie Choi, *Corporate Governance: A Board Director's Pocket Guide* (iUniverse 2010) 12 And major firms’ official websites.

⁶³³ “A shareholder activist is a person who attempts to use his or her rights as a shareholder of publicly-traded corporation to bring about social change”. See *ibid* 12.

⁶³⁴ A hedge fund may include commodities, bonds, real estate, and/or other types of asset, or it could be a general private investment partnership. It is a very competitive industry. See Richard C. Wilson, *The Hedge Fund Book: A Training Manual for Professionals and Capital-Raising Executives* (Wiley 2010) 5-13.

⁶³⁵ Jacopo Crivellaro and Milosz Morgut, ‘The End of Nocuous Relations? New Shareholders, Poison Pills and Markets for Corporate Control’ (2012) 3 IBLJ 349, 351.

⁶³⁶ Ibid 351.

taken time and expended negotiation power.⁶³⁷ One perspective is that the aim of adopting a takeover defence tactic might not be refusing a bidder's offer, but negotiating a reasonable, and highest possible price for target shareholders to tender their shares. It is also worth noting that the Delaware law that approved the poison pill, as well as the poison pill itself, could continue to evolve over time. As discussed previously, the usage of the pill in tax management issues highlights that the defence tactic is becoming more sophisticated in respect of corporate governance.

According to existing research, more poison pills were adopted during the recession, when equity prices fell down dramatically such that companies tried to use these defence measures pro-actively, to “protect shareholders in a period of market volatility”.⁶³⁸ From the perspective of purely financial issues, the poison pill could modify shareholders' rights once triggered, as mentioned earlier. The different rights between preferred shareholders and common shareholders could become a legal issue⁶³⁹ because it could be said to treat shareholders unequally.

⁶³⁷ China Merger and Acquisition Research Centre and Hollyhigh International Capital, *China Merger and Acquisition Review*, vol 2 (Tsinghua University Press 2004) 164.

⁶³⁸ Mark d. Gerstein, Bradley C. Faris and Christopher R. Drewry, ‘The Resilient Rights Plan: Recent Poison Pill Developments and Trends’ (April 2011) 35 <<http://www.lw.com/knowledglibrary>> accessed 13 August 2013.

⁶³⁹ Allan M. Chapin, ‘Takeover Defenses in the United States’ (1988) 3 IBLJ 323, 327.

Research also suggests that the poison pill may hamper or even prevent the success of a friendly tender offer because it will be triggered at a certain percentage of share holdings and does not distinguish a tender offer from a hostile takeover.⁶⁴⁰

Nonetheless, consistently with the cases presented above, the target company could still be attractive because its value and share price may increase as a result of the announcement of a potential takeover. Hostile takeovers might therefore even be welcomed in a developing market, such as China. Indeed, since early 2014 China has been encouraging the preferred shares, which are well developed in American market come. Such shares fill in the gap between China's market and the advanced ones.⁶⁴¹

Usually, however, preferred shares do not carry any voting rights unless certain conditions are met:

- (1) Amendment of provisions related to preferred shares in corporate articles; (2) reduction of more than 10 per cent of corporate registered capital; (3) corporate mergers, divisions, dissolutions or changes of corporate form; (4) issuing preferred shares; (5) other circumstances in corporate articles.⁶⁴²

Given this regulation, the poison pill might be applicable in China's market because the different levels of voting right given to the preferred shares could be written into

⁶⁴⁰ Ibid 331.

⁶⁴¹ Mingfang Zhu, 'Youxian Gu Shidian Shi Woguo Ziben Shichang Fazhan de Zhongyao Yi Bu [Experienmental Units of Preferred Shares are key steps of the Development of China's market]' (2014) 5 Development Research 23.

⁶⁴² Section 1 Article 6, Administrative Measures of Preferred Shares Experimental Units 2014.

corporate articles and, once the company meets a hostile bidder, could trigger a poison pill to protect the company. In addition, the power to make the decision whether to give voting rights to these preferred shares is still in the hands of the shareholders, and not the managers, because this regulation requires that:

The decisions of above matters should be made by at least two thirds of the normal share shareholders who attended the meeting and at least two thirds of preferred shares shareholders (excluding voting rights restored preferred shares shareholders) who attended the meeting.⁶⁴³

Thus, China's takeover regulation is still shareholder-friendly, like the UK, but now also has some American features. The issuance of Administrative Measures of Preferred Shares Experimental Units in 2014 provided a legal environment of the introduction of poison pills in China and there is no regulation clearly prohibits the adoption of poison pills. If the authority approves the issuance of preferred shares, the adoption of poison pills could be possible in China.

3. Scorched Earth Policy

1) Definition & Features

Scorched earth is an internecine takeover defence measure that aims to defend against a hostile takeover bidder by selling, or even destroying valuable assets in order to

⁶⁴³ Ibid.

make the target less attractive to bidders and/or trying to make more time for the directors to find a white knight. Scorched earth often includes two kinds of measures: the “crown jewels” and/or “puffiness tactics”. “Crown Jewels” refers to the most valuable part of a company, which is also the most attractive part for the hostile bidder. It could be a subsidiary, branch office or department, or it could be some assets, a business licence or business profession. It could also be a technology secret, patent, or key skilled talent - or any combination of these factors. “Puffiness tactics” aim at raising the ratio of debt to equity in order to discourage a hostile raider.⁶⁴⁴ It often requires distributing a good amount of cash dividends or repurchasing stock so that the indebtedness will be increased.⁶⁴⁵ Once the debts are raised, a hostile bidder might consider more carefully controlling the target because it may require additional funds. Thus the puffiness tactic could possibly lower the target’s attractiveness. As a matter of fact, the sale of crown jewel assets, or the purchase of assets which may raise obstacles for potential bidders could be used as a pre-emptive defensive option in the UK but shareholders approval is typically required.⁶⁴⁶

2) How it works

As the crown jewels are attractive to bidders, a defensive tactic that depends on their sale or mortgage reflects the intention of a target company to get rid of major inducements to hostile bidders. It is worth noting that Courts in the United States will

⁶⁴⁴ Allan M. Chapin, ‘Takeover Defenses in the United States’ (1988) 3 IBLJ 323, 330.

⁶⁴⁵ Ibid 331.

⁶⁴⁶ Stephen Kenyon-Slade, *Mergers and Takeovers in the US and UK : Law and Practice* (OUP 2004) 696.

only allow the selling of crown jewels on the basis of a “business judgement rule” and the sale requires itself that is “at arm’s length”.⁶⁴⁷ This could be understandable because the crown jewels may be the crucial part of a company, and if the directors make a wrong decision this could result in the failure of the target company’s business in the following days.

If a company is in a good financial shape with a sound business structure and high asset quality, it is often attractive to hostile bidders. The puffiness tactic seeks to alter this, in one or multiple ways: the target company may purchase lots of assets, which are not related to their business area, or deteriorate their financial status, increasing the investment risk. These measures could make the target company less attractive to bidders because even if a bidder successfully took over the target company, the high debt will make the deal unprofitable. Even if the bidder was not concerned about high debt levels, a “puffed” target company is no longer the target it used to be. Whatever is done in using the puffiness tactic aims at decreasing the value of the target company, so no matter what the target company does specifically, it will increase the risks associated with taking it over.

3) Case study

A notable case where a scorched earth policy was invoked was Jademan and Singtao News Group, in 1988. The chairman of Jademan, Zhenlong Huang (hereafter, Huang), was talented in drawing comic books and established a comic empire in 1979 when

⁶⁴⁷ Allan M. Chapin, ‘Takeover Defenses in the United States’ (1988) 3 IBLJ 323, 330.

his business became the dominant corporation in comic book selling in Hong Kong. The Jademan Corporation took more than 80 per cent of the sales volume of the Hong Kong comic business and was listed on the market in 1986.⁶⁴⁸ Shortly after, Singtao started to acquire Jademan's stock and became the secondary shareholder, eventually owning about 30 per cent of the shares.⁶⁴⁹ To defend Singtao and protect Huang's empire, he used a scorched earth policy to lower the attractiveness of Jademan. Specifically, two of Jademan's crown jewels were sold: the Jademan Central Building, and its main media press, the Daily News. To sell these major assets, Huang needed the consent of the board of shareholders. Ultimately, Huang achieved his goal as the board of shareholders passed the decision to sell these assets and Singtao gave up the aim of controlling the Jademan Corporation.

4) Summary

The scorched earth policy is a form of restructuring defence which has proven effective as it can help the target company get rid of what the hostile bidder is interested in.⁶⁵⁰ However, it also receives much criticism. A scorched earth policy can be dangerous to a target company. Once the defensive measure successfully lowers the target's attractiveness, it is likely to be less valuable than before, because of the sale of its crown jewels or the high debts raised.

⁶⁴⁸ Yungeng Xie, 'Media Takeover and Anti-takeover [Chuanmei Binggou yu Fan Binggou]' (People.com, 7 July 2005) <<http://media.people.com.cn/GB/40628/3524651.html>> accessed 01 Aug 2013.

⁶⁴⁹ Guohua Zhao, *Shang Jie -- Shangzhan Naxie Ju* (IP Press 2012) 35.

⁶⁵⁰ Allan M. Chapin, 'Takeover Defenses in the United States' (1988) 3 IBLJ 323, 330.

Evidence showed that corporations with “crown jewels” are prime targets for hostile raiders,⁶⁵¹ because these may be the most profitable parts of the company and/or responsible for most of its value. That said, selling the crown jewels or puffing up a company does not necessary mean making that company worthless. Saving control of the company aims at helping the target company move through the risk of being taken over by a hostile raider. Ultimately, target companies should use this tactic very carefully.

Since this tactic can be harmful to both the target and bidding company, it might not be suitable for China’s market. According to China’s Company Law, one of the major duties of the directors is to protect the best interests of the company.⁶⁵² Such a risky method does not meet this requirement and so cannot be used. Moreover, is likely to be banned by the supervisory department according to Article 8 of the *Takeover Measures* because of its inherent violation of directors’ duties. Even if the directors can gain the approval of shareholders, the process of organising a shareholding meeting can be very time-consuming, losing efficiency as a takeover defensive tactic. More importantly, it seems reasonable that shareholders would like having premiums rather than having a less valuable shell company. Thus, to protect the best interest of the shareholders and the long-term development of target companies, legalising this tactic is not a good idea.

⁶⁵¹ Tilton L. Willcox, ‘The Use and Abuse of Executive Powers in Warding off Corporate Raiders’ (1988) 7 *Journal of Business Ethics* 47, 49.

⁶⁵² Company Law of the People’s Republic of China (2005 Revision) a.59.

4. Shark Repellents

1) Definition & Features

The shark repellent defence tactic focuses on making amendments to a company's constitution to repel an acquirer from taking over a target company by introducing unfriendly factors into the target's articles and making the target less attractive to bidders.⁶⁵³ During the 1980s, a peak period for merger and acquisition activities in the US, hostile bidders were often called "sharks"; thus from that time, certain anti-takeover tactics became known as "shark repellents".⁶⁵⁴ This tactic includes a series of measures that are achieved through setting special terms in the articles of corporation; these are the staggered board, supermajority terms, and fair price provision.

2) How it works

The staggered board means that only some of the directors of a target company will be elected at each election, instead of changing them *en masse*. This means that, even when a hostile bidder successfully takes over, they cannot gain control of the board of directors in a short time.⁶⁵⁵ A staggered board is often accompanied by a

⁶⁵³ Ronald J. Gilson, 'The Case against Shark Repellent Amendments: Structural Limitations on the Enabling Concept' (1982) 34 Stanford Law Review 775, 777.

⁶⁵⁴ Shuo Wang and Qing Guan, 'Sohu and APTECH, Poison Pill' (Caijing Magazine, 26 November 2001) <<http://tech.sina.com.cn/i/2005-02-23/0116532418.shtml>> accessed 18 August 2013.

⁶⁵⁵ Wenxia Zhou, 'The Value Analysis and Legislation Selection of Anti-takeover Actions - Concurrently Discuss the Application of Anti-takeover Measures in China' (Masters Thesis, Jilin University 2008) 29.

poison pill, and with the help of the pill, the staggered board can be potent in defending against hostile bidders because it makes it difficult for said bidder to win the proxy fight to control the company.⁶⁵⁶

A super majority provision allows the target company to amend its corporate constitution - if it is not against the law - and to add some provisions that require super majority shareholder approval.⁶⁵⁷ In this circumstance, a super majority usually requires 75 to 80 per cent.⁶⁵⁸ This measure places obstacles in the way of hostile bidders seeking to control the target company's board. For example, if super majority approval is required to change the CEO of the target company, if a hostile takeover is successful, the hostile bidder will likely find it hard, or even impossible to gain the super majority of shareholders' support required to make their desired changes; thus this could make bidders less interested in a company as they may not be able to control it.

Fair price amendments indicate "a 'fair price' that the bidder must pay for all purchased shares, which is usually the highest price paid by the acquiring party during the previous year".⁶⁵⁹ This tactic is motivated by the desire to obtain a higher price

⁶⁵⁶ Pornsit Jiraporn and Yixin Liu, 'Capital Structure, Staggered Boards, and Firm Value' (2008) 64 *Financial Analysts Journal* 49, 50.

⁶⁵⁷ Liang Huang, *A Study on the Legal Regulation of Anti-takeover of Listed Corporations* (DPhil thesis, Jilin University June 2010) 55.

⁶⁵⁸ Tilton L. Willcox, 'The Use and Abuse of Executive Powers in Warding off Corporate Raiders' (1988) 7 *Journal of Business Ethics* 47, 50.

⁶⁵⁹ Mark S. Johnson and Ramesh P. Rao, 'The Impact of Anti-takeover Charter Amendments on Expectations of Future Earnings and Takeover Activity' (1999) 20 *Managerial and Decision Economics* 75, 77.

for shareholders in a hostile takeover⁶⁶⁰ yet is claimed to be ineffective in defending against a hostile bidder.⁶⁶¹ However, this fair price provision may be effective in defending against a two-tiered purchase of the target company. In effect, corporate raiders often try to control a target company in two steps: firstly, they may “purchase enough shares on the open market for a foothold and then make a tender offer for enough shares to gain control or partial control of the firm”.⁶⁶² Secondly, they might purchase shares at a lower price if the shareholder does not accept the offer the first time.⁶⁶³ This could be seen as price discrimination against those more loyal shareholders who did not accept the tender offer at the first stage. Thus, a fair price provision could help these shareholders to guarantee profits on their tendered shares.

3) Case study

These shark repellents tactics could be beneficial to retain incumbent management and help a company with lower leverage: with their use, both the target company and the bidder company might be protected.⁶⁶⁴

Shark repellent tactics are the most controversial of the pro-active management related tactics and many scholars have criticised their misuse in the US.⁶⁶⁵ It is

⁶⁶⁰ Ibid 77.

⁶⁶¹ Liang Huang, *A Study on the Legal Regulation of Anti-takeover of Listed Corporations* (DPhil thesis, Jilin University June 2010) 55.

⁶⁶² Tilton L. Willcox, ‘The Use and Abuse of Executive Powers in Warding off Corporate Raiders’ (1988) 7 *Journal of Business Ethics* 47, 48.

⁶⁶³ Ibid 48.

⁶⁶⁴ Shufang Lin, ‘Developments of the Hostile Takeover in China From the Perspective of Law’ (Masters Thesis, Fudan University 18 April 2012) 27.

claimed that most shareholders are easily misled by managers; if a target company decided to use shark repellents, especially to amend corporate bylaws, the incumbent manager may be incapable of making appropriate decisions. Incapable management teams may not perform well enough to deprive or delay the hostile takeover, and on contrary, might only aim at retaining their positions in the target company. In a famous takeover case between Mesa (the hostile bidder) and Gulf Oil, the latter's management team was trying to convince shareholders to approve a switch of its state of incorporation to Delaware which did not require cumulative voting rather than using other effective tactics to defend against the hostile bid. Ultimately, the shareholders did not receive any benefits, having been misled by management to agree to the move.⁶⁶⁶ In this case, the current boards nearly squandered the shareholders' last chance to sell their stock at its proper price.⁶⁶⁷ Thus, whether this shark repellent tactic is in the best interests of shareholders can be questioned; it could be said to be too easily used to protect incapable directors' positions.

4) Summary

Linn and McConnell suggested that the adoption of shark repellents is not likely to have a negative impact on shareholders' stocks, and nor is it likely to "lead to any

⁶⁶⁵ Tilton L. Willcox, 'The Use and Abuse of Executive Powers in Warding off Corporate Raiders' (1988) 7 *Journal of Business Ethics* 47, 53.

⁶⁶⁶ Ibid 50.

⁶⁶⁷ The market price was 40 USD per share because the company was devalued at that time but the real price of the company could have been up to 80 USD per share. See *ibid* 50.

misallocation of real corporate assets”.⁶⁶⁸ Other researchers have claimed that the adoption of shark repellents may not have any effect on takeover activity or takeover premiums, and of course the shareholders do not need to bare any consequences either.⁶⁶⁹ In any event, shark repellents can help to delay the hostile takeover process and give the board of directors more time to seek a white knight or strive for a higher tender price for shareholders.⁶⁷⁰

The staggered board tactic has been described as a soft strategy to defend against hostile bidders as it cannot impede the bidder in continuing to buy a target's shares - but used alongside other defence tactics, its effectiveness could be magnified.⁶⁷¹ It is argued that a staggered board could entrench inefficient managers.

Moreover, according to the US business judgment rule, all directors should act in good faith to protect shareholders' interests, and few shareholders are likely to vote for such an amendment because it can not only act as a takeover defence tactic, it can also act as protection for incumbent management.⁶⁷² In fact, few companies will adopt this tactic because some already had staggered board requirement in their

⁶⁶⁸ Scott C. Linn and John J. McConnell, 'An Empirical Investigation of the Impact of 'Antitakeover' Amendments On Common Stock Price' (1983) 11 *Journal of Financial Economics* 361, 398.

⁶⁶⁹ Mark S. Johnson and Ramesh P. Rao, 'The Impact of Anti-takeover Charter Amendments on Expectations of Future Earnings and Takeover Activity' (1999) 20 *Managerial and Decision Economics* 75, 86.

⁶⁷⁰ Shufang Lin, *Developments of the Hostile Takeover in China From the Perspective of Law* (Masters Thesis, Fudan University 18 April 2012) 27.

⁶⁷¹ Pornsit Jiraporn and Yixin Liu, 'Capital Structure, Staggered Boards, and Firm Value' (2008) 64 *Financial Analysts Journal* 49, 50.

⁶⁷² Nancy L. Meade and Dan Davidson, 'The Use of "Shark Repellents" to Prevent Corporate Takeovers: An Ethical Perspective' (1993) 12 *Journal of Business Ethics* 83, 87.

articles,⁶⁷³ and some by-law amendments could possibly allow directors to abuse this power, with the potential for directors to use their minority shares to vote down shareholders' suggestions if the company adopted super majority provisions.⁶⁷⁴ Shark repellents could thus increase management influence or promote stakeholders' interests.⁶⁷⁵ Shark repellent tactics could save a company from a hostile takeover yet at the same may save inefficient managers and sacrifice shareholders' short-term profits. In the long-term, however, communities may benefit from the target company remaining, via job provision and increased local revenue so that shareholders can still benefit.⁶⁷⁶ Overall, however, these potential benefits are not guaranteed and some sacrifice of shareholder's interests is likely.⁶⁷⁷ In addition, many of the US's shark repellent provisions are inapplicable in the UK, such as supermajority voting requirements, fair price shark repellents. Staggered board and shark repellents which permit the removal of a director 'for a cause' are also not generally applicable in the UK because the Companies Act allows the shareholders in general meeting to remove a director from office with or without cause.⁶⁷⁸

⁶⁷³ Elizabeth A. Raymond and Stuart M. Litwin, 'Mergers and Acquisitions in the United States: Review of Defensive Charter and By Law Provisions for Delaware Incorporated Companies' (1996) 7 ICCLR 104, 104.

⁶⁷⁴ Xu Li, 'Research on Comparisons of Takeover Restrictive Regulations Between China and Korea' (Masters Thesis, Fudan University 2011) 38.

⁶⁷⁵ Nancy L. Meade and Dan Davidson, 'The Use of "Shark Repellents" to Prevent Corporate Takeovers: An Ethical Perspective' (1993) 12 Journal of Business Ethics 83, 84.

⁶⁷⁶ Ibid 90.

⁶⁷⁷ Ibid 84.

⁶⁷⁸ Companies Act 2006 a.168.

These tactics do not require a highly developed market, nor a specific legal system, so they could be utilised in China as well as elsewhere. China's Company Law only regulates directors' terms of office, without requiring that every director should share the same term,⁶⁷⁹ thus making a staggered board possible. Additionally, China only regulates that there be a minimum standard for shareholders to vote regarding the major affairs of the listed company, but no specific limit is set.⁶⁸⁰ This therefore makes super majority terms feasible in China. Ultimately, any terms added into the corporate articles that do not violate the principles of China's Company Law and directors' duties could feasibly be used to defend against a possible hostile takeover.

5. Dual Class Recapitalization

1) Definition & Features

⁶⁷⁹ According to Article 46 of China's Company Law, "The terms of office of the directors shall be provided for in the articles of association, but each term of office shall not exceed 3 years. The directors may, after the expiry of their terms of office, hold a consecutive term upon re-election. If no re-election is timely carried out after the expiry of the term of office of the directors, or if the number of the members of the board of directors is less than the quorum due to the resignation of some directors from the board of directors prior to the expiry of their term of office, the original directors shall, before the newly elected directors assume their posts, exercise the authorities of the directors according to laws, administrative regulations as well as the articles of association." According to Article 109, "A joint stock limited company shall set up a board of directors, which shall comprise 5-19 persons." No specific regulations are included in the Company Law to indicate that directors should have same term of office.

⁶⁸⁰ According to article 104 of the Company Law of the People's Republic of China (2005 Revision), "When the shareholders' assembly makes a decision to modify the articles of association or to increase or reduce the registered capital, or a resolution about the merger, division, dissolution or change of the company form, the resolution shall be adopted by shareholders representing 2/3 or more of the voting rights of the shareholders in presence."

A Dual Class Share Structure is also been referred to as “Dual Class Recapitalization”.⁶⁸¹ This defence measure creates two classes of shares “and involves the issue of stock with different voting rights from the firm’s existing common stock”.⁶⁸²

2) How it works

The plan is usually achieved through issuing two classes of shares - class A and class B - with different voting rights. This creates two classes of shareholders, “one class with more voting privileges than the other class”.⁶⁸³ When a target company adopts this plan, it makes shares with voting rights different from common shares, and privileged shares with voting rights have “lower dividends or reduced marketability”.⁶⁸⁴

3) Case study

A few years ago, a Chinese company, Baidu Inc., used this tactic to prevent its potent competitor Google in the US. In 2005, Baidu Inc. submitted its prospectus to SEC to express its intention to list on the US market, NASDAQ. This dual class plan was

⁶⁸¹ Qingkai Meng, ‘Preactive Takeover Defense Measures in the Listed Companies in the Global Environment [Quanqiu Tong Huanjing Xia Shangshi Gongsi Fan Shougou de Shixian Fangyu Cuoshi]’ (2007) 7 Business Culture 17. This is different from a Chinese shareholding structure, because non-tradable shares cannot be purchased in the market; dual class shares are traded in the market but with different rights.

⁶⁸² Uma V. Sirdharan, ‘Dual Class Plans and Unequal Voting Rights Plans: A Managerial Choice’ (1997) IX Journal of Managerial Issues 230, 230.

⁶⁸³ Ibid 232.

⁶⁸⁴ Ibid 232.

mainly intended to prevent one of its investors – Google - from becoming a hostile bidder.⁶⁸⁵ In this prospectus, it noted that Baidu would issue two classes of shares with different voting rights: One, the class A share, would be the common share held by common shareholders, traded in the market, and which carried 1 vote per share. The other, the class B share, would be the privileged share, conferring 10 votes per share and held only by original shareholders (mostly the founders of Baidu).⁶⁸⁶ At this ratio, even if outside investors took over 13.4 per cent of Baidu's shares, they could only get a 1.5 per cent say, meaning there would be no takeover threat for Baidu.⁶⁸⁷ The founder of Baidu, Yanhong Li, owned 25.8 per cent of Baidu's privileged shares, meaning he had (has) absolute control of the company.⁶⁸⁸ The dual class recapitalization plan worked very well in giving Google almost no chance to control Baidu.

4) Summary

The dual class recapitalization plan was popular in the 1980s and 1990s in the US, but as it distinguishes between two classes of shareholders, it can be seen as discriminating against common shareholders, and so this plan has not frequently been

⁶⁸⁵ Yuxiang Xiong, 'Baidu IPO Niuka Jihua Suo Yinhan de Xintuo Qiyue zhi Paoxi' (*JRJ.com*, 06 July 2009) <<http://trust.jrj.com.cn/2009/07/0618595435727.shtml>> accessed 20 August 2013.

⁶⁸⁶ Zhong Ji Newspaper, 'Dual Class Plan Baidu's Plan' (*163.com*, 02 August 2005) <<http://tech.163.com/05/0802/09/1Q50UTSU000915BF.html>> accessed 13 August 2013.

⁶⁸⁷ Serena Ng, 'Baidu Plays Defense on Voting Rights' (*The Wall Street Journal*, 18 August 2005) <<http://www.marketwatch.com/story/baidu-plays-defense-on-voting-rights-2005-08-19>> accessed 22 August 2013.

⁶⁸⁸ Zhong Ji Newspaper, 'Dual Class Plan Baidu's Plan' (*163.com*, 02 August 2005) <<http://tech.163.com/05/0802/09/1Q50UTSU000915BF.html>> accessed 13 August 2013.

used in recent years.⁶⁸⁹ One reason could be that the voting ratio of a dual class plan between voting shares and common shares is usually over the limit permitted by corporation law in most of the jurisdictions.⁶⁹⁰

In the UK, Takeover Code requires shareholders be treated equally, so this policy cannot work there. Moreover, the UK's takeover activities are additionally influenced by EU regulations, and the Directive 2004/25/EC requires all member states to treat shareholders fairly.⁶⁹¹

China's Company Law requires that all the shares be issued on a fair basis;⁶⁹² that is to say, each share issued at the same time should have the same rights and price. This means such shares cannot be divided into two classes.

6. Three kinds of 'Parachutes' – Golden, Silver, and Tin

1) Definition & Features

⁶⁸⁹ Lucian Arye Bebchuk, Reinier Kraakman and George G. Triantis, 'Stock Pyramids, Cross-Ownership, and Dual Class Equity' in Randall K. Morck (ed), *National Bureau of Economic Research* (University of Chicago Press 2000) 297.

⁶⁹⁰ Ibid 297.

⁶⁹¹ The Takeover Code (Eleventh edition) 2013 Rule 11, 12 and 20. Also, according to the "introduction" part of the Code, it could be known that the Takeover Code "is based upon a number of General Principles, which are essentially statements of standards of commercial behaviour. These General Principles are the same as the general principles set out in Article 3 of the Directive".

⁶⁹² Company Law of the People's Republic of China (2005 revision) a.127.

“Parachutes” are protections against displacement of executives⁶⁹³ that mainly focus on payments made to directors and/or employees once a hostile takeover is triggered and they run the risk of losing their jobs.⁶⁹⁴ Parachute strategies might be seen as a kind of shark repellent tactic by some scholars because they serve the function of repelling hostile bidders.⁶⁹⁵ There are three kinds of parachutes that a target company could employ (or deploy): the golden parachute, the silver parachute, and the tin parachute. These three have similar functions but focus on different groups of people.

A golden parachute is a severance package given to senior managers who can utilize it once a takeover has occurred.⁶⁹⁶ A silver parachute is a similar package given to lower-level executives, and a tin parachute is similar, again, but for even lower-level managers and employees.⁶⁹⁷

2) How it works

The term of “golden parachute” originated in 1961 when the first example of a golden parachute clause was included in the contract of the former chairman of TWA –

⁶⁹³ Edwin T. Hood and John J. Benge, ‘Golden Parachute Agreements: Reasonable Compensation or Disguised Bribery’ (1984) 53 UMKC L Rev 199, 202 note 13.

⁶⁹⁴ John A. Pearce and Richard Robinson, ‘Hostile Takeover Defenses that Maximize Shareholder Wealth’ (2004) 47 Business Horizons 15, 24.

⁶⁹⁵ Edwin T. Hood and John J. Benge, ‘Golden Parachute Agreements: Reasonable Compensation or Disguised Bribery’ (1984) 53 UMKC L Rev 199, 200.

⁶⁹⁶ Patrick A. Gaughan, *Mergers, Acquisitions, and Corporate Restructurings* (5th edn, John Wiley & Sons 2010) 186.

⁶⁹⁷ Albert Choi, ‘Golden Parachute as a Compensation-Shifting Mechanism’ (2004) 20 J of L Econ & Org 170, 171.

Charles Tillinghast, Jr.⁶⁹⁸ His contract included a good amount of money paid in the event of his losing his job – however, this “parachute never opened”.⁶⁹⁹ This vividly illustrates issues relating to letting chief executives leave their position safely and just like the parachute which is protecting people who drop from high place so this tactic is called the golden parachute.⁷⁰⁰ In fact, provision of a golden parachute requires the approval of the board of directors and can be established by way of a contract between CEO and target that includes terms giving chief managers high compensation after removal from the target company if the company is taken over by a bidder.

A silver parachute is part of lower-ranking executives’ employment contracts, and promises good compensation “before the possibility of a takeover or a merger”.⁷⁰¹ Mostly, silver parachute terms include a promise of paying these managers a certain amount of money, usually equivalent to several weeks’ or months’ salaries, depending on their working ages. Compared with the compensation offered by golden parachutes, however, silver parachutes are much smaller.⁷⁰² As for tin parachutes, these are seldom used, covering only lower-level employees’ compensation. These apply if a

⁶⁹⁸ Claire Suddath, ‘Biggest Golden Parachutes’ (*Times*)

<http://www.time.com/time/specials/packages/article/0,28804,1848501_1848500_1848418,00.html> accessed 11 August 2013.

⁶⁹⁹ Ibid.

⁷⁰⁰ Yungeng Xie, ‘Media Takeover and Anti-takeover [Chuanmei Binggou yu Fan Binggou]’ (People.com, 7 July 2005) <<http://media.people.com.cn/GB/40628/3524651.html>> accessed 01 Aug 2013.

⁷⁰¹ Albert Choi, ‘Golden Parachute as a Compensation-Shifting Mechanism’ (2004) 20 *J of L Econ & Org* 170, 171.

⁷⁰² Randy Myers, ‘Minimize Parachute Penalties’ (*Journal of Accountancy*, October 2001) <<http://www.journalofaccountancy.com/Issues/2001/Oct/MinimizeParachutePenalties.htm>> accessed 20 August 2013.

target company is taken over by a hostile bidder and if their job is lost within the following two years.⁷⁰³

According to the Internal Revenue Code, 20 per cent excise tax is charged on parachute payments, and this kind of tax could not be deducted.⁷⁰⁴ This tax exists because companies could otherwise use these tactics as an alternative form of extra pay.

3) Case study

Golden parachutes were frequently used in the US in the 1980s because of the popularity of hostile takeovers and some active hostile raiders, such as Carl Icahn and T. Boone Pickens.⁷⁰⁵ As hostile takeovers might cause a target's directors to lose their jobs, parachutes were popular in seeking to reassure managers that they would receive a high payment in such a case.

One example of their use can be found in the fight between the Gulf Oil Corporation and the Mesa Corporation. It was suspected that the golden parachutes existed that were worth approximately ten million dollars; these helped the giant Gulf Oil

⁷⁰³ Liang Huang, *A Study on the Legal Regulation of Anti-takeover of Listed Corporations* (DPhil thesis, Jilin University June 2010) 58.

⁷⁰⁴ Patrick A. Gaughan, *Mergers, Acquisitions, and Corporate Restructurings* (5th edn, John Wiley & Sons 2010) 620.

⁷⁰⁵ Paul M. Hirsch, 'From Ambushes to Golden Parachutes: Corporate Takeovers as an Instance of Cultural Framing and Institutional Integration' (1986) 91 *American Journal of Sociology* 800, 814.

successfully defend against the raider.⁷⁰⁶ In another case, Stan O’Neal, the previous CEO of Merrill, received about 159 million USD (77 million GBP) as a golden parachute for his loss of job in 2007; this tactic, and this pay-out, attracted much criticism at that time.⁷⁰⁷

Evidence shows, however, that golden parachutes are still in style. In 2002, as reported by the *New York Times*, a record parachute pay out was received by James J. Mulva, the CEO of Conoco Philips for 10 years. The total size of his package was approximately 156 million USD, which placed him at the top of managers’ high salary list.⁷⁰⁸ Even more recently, in 2014, Dazhong Gongyong included golden parachutes into its corporate articles that apply if a hostile takeover causes directors to lose their job directly or indirectly, meaning that shareholders will be obliged to compensate the directors for extra fees.⁷⁰⁹ This is aimed at increasing the takeover cost, and therefore decreasing takeover attractiveness.

4) Summary

All three parachutes are similar and both silver and tin parachutes can simply be seen as lower-level variations of golden parachutes. As an anti-takeover measure,

⁷⁰⁶ Tilton L. Willcox, ‘The Use and Abuse of Executive Powers in Warding off Corporate Raiders’ (1988) 7 *Journal of Business Ethics* 47, 51.

⁷⁰⁷ Andrew Clark, ‘Merrill Lynch, the Firm Lost \$8bn and the Chief Executive Had to Go - With \$159m’ (*The Guardian*, 30 October 2007) <<http://www.theguardian.com/business/2007/oct/30/6>> accessed 20 August 2013.

⁷⁰⁸ Pradnya Joshi, ‘Golden Parachutes Are Still Very Much in Style’ (*NY Times*, 29 June 2013) <http://www.nytimes.com/2013/06/30/business/golden-parachutes-are-still-very-much-in-style.html?pagewanted=all&_r=0> accessed 25 August 2013.

⁷⁰⁹ Nan Jiang, ‘Takeover and Anti-takeover Strategies in Practise’ (2014) 7 *Top CFO* 60, 60.

parachutes may force an increase in takeover budget or necessitate a larger cash outlay for the bidding company, and hold up the takeover process.⁷¹⁰ Also, as it is introduced that the “parachute” tactic could be seen as a kind of shark repellent measures, so it is also not applicable without the shareholders’ approval due to the rules set in the Code.⁷¹¹

Empirical research has been conducted into the incidence of golden parachutes and the differential compensation-tenure relationship for managers in a sample of 331 firms.⁷¹² This study showed that the golden parachute was of benefit and “arose to assure managers against tender related opportunism”.⁷¹³ The primary purpose of parachutes is to distribute the accumulated wealth of the company to employees - this can also make the target less attractive for the hostile bidders. However, as a tactic, it does not seem to be of value to shareholders, whom it is argued do not benefit from their use. In considering this point, it could therefore be said that “directors may be in violation of their fiduciary duty”.⁷¹⁴

On this point, a study also showed that both shark repellents and golden parachutes could help target company shareholders ensure directors’ reliability by offering them

⁷¹⁰ Yungeng Xie, ‘Media Takeover and Anti-takeover [Chuanmei Binggou yu Fan Binggou]’ (People.com, 7 July 2005) <<http://media.people.com.cn/GB/40628/3524651.html>> accessed 01 Aug 2013.

⁷¹¹ The Takeover Code 2013 Rule 21.1.

⁷¹² Charles R. Knoeber, ‘Golden Parachutes, Shark Repellents, and Hostile Tender Offers’ (1986) 76 *The American Economic Review* 155, 166.

⁷¹³ *Ibid* 166.

⁷¹⁴ Allan M. Chapin, ‘Takeover Defenses in the United States’ (1988) 3 *IBLJ* 323, 326.

a contract that simultaneously makes both parties – shareholders and managers – better off if accepting a bidder's offer.⁷¹⁵ In other words, this could reduce the likelihood of a situation whereby managers would defend against any hostile offer whatsoever, to avoid losing their jobs (since a successful takeover could be a threat to the directors' positions). Work by Richard Lambert and David Larcker revealed that golden parachutes had a favourable effect on major directors' actions over the management of target companies and also had a positive effect on the price of target company's securities in the market.⁷¹⁶ That said, it could also be argued that parachutes are not a fair tool for a target company as they give too much protection for directors even if said directors acted foolishly, or were incompetent.⁷¹⁷ The golden parachute may otherwise also cause a lower takeover premium for a company if a situation arises where the target's managers "are too eager to sell the company to receive [a] large payment".⁷¹⁸

7. Other takeover defence tactics

There are also some other takeover defensive tactics that may not be very frequently used or very well known, but could be very useful in certain circumstance.

⁷¹⁵ Charles R. Knoeber, 'Golden Parachutes, Shark Repellents, and Hostile Tender Offers' (1986) 76 The American Economic Review 155, 166.

⁷¹⁶ Richard Lambert and David Larcker, 'Golden Parachutes, Executive Decision-Making and Shareholder Wealth' (1985) 7 Journal of Accounting and Economics 179, 201.

⁷¹⁷ Randy Myers, 'Minimize Parachute Penalties' (Journal of Accountancy, October 2001) <<http://www.journalofaccountancy.com/Issues/2001/Oct/MinimizeParachutePenalties.htm>> accessed 20 August 2013.

⁷¹⁸ Albert Choi, 'Golden Parachute as a Compensation-Shifting Mechanism' (2004) 20 J of L Econ & Org 170, 184.

One example is the people pill, which is where the management team or professional employees resign at the same time en masse once a hostile takeover succeeds, and can be useful in specific situations. This measure could work in some hi-tech businesses in which employees with special knowledge are important to the corporation and are of great value to the company.⁷¹⁹

Second, the target company could use management buyout (MBO) to defend against a hostile takeover. An MBO is when the managers/directors of the target company use the assets of the company or future profits as a guarantee for finance from the market or their shareholders, and they use the funds to buy shares of the target company in order to have the control over it. Consequently, the managers of the target company become the owner of the company at the same time, which could help the company to reduce agency costs and promote the directors' positivity.⁷²⁰ However, this tactic is not legal in China; it is very risky to finance an MBO. Indeed, in order to finance an MBO, managers usually use the company as a guarantee for a loan from the bank to purchase shares, or mortgage existing shares to the bank to get the purchase money. In this case, the managers only have rights over the purchased shares but have no responsibility to pay the money back if the MBO fails.⁷²¹ According to China's

⁷¹⁹ Katerina S. Kokot, 'The Art of Takeover Defence' (2006) September The Ukrainian Journal of Business Law 18, 20.

⁷²⁰ Peking University Research Group of Guanghua School of Management, *Listed Companies' Takeover Defence Tactics and Relevant Regulations in China [Zhongguo Shangshi Gongsi de Fan Shougou Cuoshi jiqi Guizhi]* (Fudan Press 2003) 166-167.

⁷²¹ Xiying Cai and Kankan Xu, 'Some Thoughts On Management Buyout' (2004) 5 *Caikuai Tongxu* 42, 44.

Interim Measures for the Management of the Transfer of the State-owned Property Right of Enterprises, certain types of SOEs, such as the state-owned high technology enterprises, could not use MBO without the approval of the government, to prevent the loss of state assets.⁷²²

The board of directors can go against a hostile takeover offer for the good of target companies. That is to say, the directors could make a decision that the hostile offer is not good for the target company and try to defend against the hostile raider. There was one such case in China in 2001, between Jinan Department Store and Huajian Electron. In that bid, the board of directors in Jinan Department Store approved the rejection of a takeover offer from Huajian Electron in defiance of the Jinan Department Store's major shareholder – the Jinan Treasury. Ultimately, the actions of the directors were approved of as in the best interest of the shareholders because Huanjian did not have the ability to provide sufficient finance to take over Jinan Department Store;⁷²³ however, this tactic relied on the fiduciary obligation of the directors to ensure their actions were in the interest of shareholders of the target

⁷²² Interim Measures for the Management of the Transfer of the State-owned Property Right of Enterprises, a.12. "If a State-controlled high technology enterprise or a scientific research institution subject to restructuring which satisfies the provisions of the State Council General Office, Transmission of the Circular (Guo Ban Fa [2002] No. 48) and the State Council General Office, Transmission of the Circular (Guo Ban Fa [2003] No. 9) needs to assign State-owned equities of the enterprise to the management in carrying out pilot projects of equity incentives, it shall apply to the department in charge of finance at or above the provincial level or the relevant State-owned assets supervision and administration authority for approval".

⁷²³ Peking University Research Group of Guanghua School of Management, *Listed Companies' Takeover Defence Tactics and Relevant Regulations in China* [Zhongguo Shangshi Gongsi de Fan Shougou Cuoshi jiqi Guizhi] (Fudan Press 2003) 140-141.

company. This could be seen as a special takeover defensive tactic, led by the directors themselves. The directors played a defence against a takeover measure, but this required sufficient experience on their part in accurately recognising that the hostile offer was not good for the target company; given that being so, this defence was therefore a success. Had this not been the case, such a tactic could be dangerous, since it is possible that directors might be acting in their own interests.

8. Summary of this group of takeover defence measures

Most of these management-related defensive measures are only used in the US, because the US takeover defence regulation is more director-friendly. In the UK, “the target company shareholders ultimately determine the success or failure of a hostile offer, and the directors do not have the power to prevent shareholders’ choice to the same extent as in the US”.⁷²⁴ Such differences give specific takeover defence measures a very different legal status across these countries. That could be caused by the following factors: firstly, the composition of shareholders may change the legislator’s attitude towards defence measures. As discussed in previous chapters, there were many family-owned corporations in the US, and then institutional investors started to show up in the market. Some of the management-related takeover defence could protect a family business with the help of professionals. Tactics such as the poison pill and shark repellents could provide strong pro-active protection for

⁷²⁴ Stephen Kenyon-Slade, *Mergers and Takeovers in the US and UK : Law and Practice* (OUP 2004) 694.

target companies, but these measures require directors to act in good faith, which is not easy to guarantee. At the same time, new players in the market are considerably reducing the number of poison pills adopted by target companies. In respect of the scorched earth policy, this can be seen to best represent a last choice for a target company to defend itself. Once a crown jewel is sold, the target company's long-term development is likely to be harmed, even if the policy prevents a hostile takeover. However, if the target company finds a white knight to secure these crown jewels - and this white knight does not become a grey knight - a "scorched earth policy" could be considered. In the US market, Delaware General Company Law allows for the availability of a range of takeover defence tactics because of the US mature market structure and because States seek to attract incorporations and thus make director-friendly rules. Indeed, Federal legislation seldom has an effect over state legislation in takeover activities, and most US states are inclined to protect its own state's business by allowing directors the power to use such takeover defence measures as they deem appropriate. Each state cares for their own corporations' existence more than the federal economic situation as a whole, and the US "business judgement rule" exists to reassure shareholders and legislators that they can trust directors to fight against hostile bidders in shareholders' interest. It has been argued that target corporations may have different political influence on how states legislate for the states in the US since the US is a federation,⁷²⁵ and this could be the one

⁷²⁵ Hui Li, *Study on Anti-takeover Provisions of the Charter of the Corporation and Its Legal Regulation* (Masters Thesis, Southwestern University of Finance of Economics 2008) 26.

reason why every state would prefer a director-friendly system to protect its domestic corporations. Some defensive tactics also receive much criticism in the US, and this illustrates how important the nomination of directors is important in the US legal environment.⁷²⁶ Directors should act professionally during take over and the hostile defence processes.

There are more institutional investors in the UK market and institutional investors are typically more focused on profits and not the business itself. In addition, it is said that these shareholders can “reduce the free-rider problem associated with monitoring managers”.⁷²⁷ Thus it is understandable that these professional market players trust themselves more than the directors to control the company. Accordingly, it is reasonable that institutional shareholders will wish to have control over the use of defensive tactics, and to decide whether to accept a hostile bid or not. Given that the directors may be acting in their own interests and, under Rule 21 of the UK Takeover Code,⁷²⁸ directors are prohibited from taking action to frustrate deals unless they have the consent of the shareholders, meaning that takeover defence measures are less frequently used than in the US. There is also an independent department in the UK to resolve issues that arise in takeovers. In addition, the UK market is a uniform one and

⁷²⁶ Paul M. Hirsch, ‘From Ambushes to Golden Parachutes: Corporate Takeovers as an Instance of Cultural Framing and Institutional Integration’ (1986) 91 *American Journal of Sociology* 800, 821.

⁷²⁷ Anup Agrawal and Gershon N. Mandelker, ‘Shark Repellents and the Role of Institutional Investors in Corporate Governance’ (1992) 13 *Managerial and Decision Economics* 15,22.

⁷²⁸ The City Code on Takeovers and Mergers Rule 21 outlines some circumstances when shareholders’ consent is required, and these circumstances include the use of all the stated takeover defence measures.

this reduces the competition for incorporations and consequent director-friendly rule making.⁷²⁹ At the same time, in the UK, both the target and bidder company could have an impact. With the existence of those institutional investors who are professional market players, it is understandable that UK legislators provide self-regulated takeover protocols for the market.⁷³⁰ Moreover, the UK is also part of the European market and for all takeover-related issues is required to adhere to the rules of the EU Directive to promote the integration of the EU market.⁷³¹ The EU regulations require target boards to be strictly neutral in the takeover process.⁷³² Thus, legislators are reluctant to give the directors more power than shareholders. That is to say, all crucial decisions should be made by shareholders and not by directors. The emergence of defensive measures in the market may also influence the UK, since these professional players may push the success of hostile takeovers if a bidder offers a good price for shareholders. Because some of the measures described (such as the poison pill, and scorched earth policy) are too powerful to fail, applying due consideration of shareholders' benefits, it may be best to prohibit these takeover defences. In fact, the target board's defensive options in response to a hostile offer are strictly curtailed in the UK, and in most cases there are 3 most viable options for the directors: 1) "defence document—strong criticism by the target's board of directors

⁷²⁹ Hui Li, *Study on Anti-takeover Provisions of the Charter of the Corporation and Its Legal Regulation* (Masters Thesis, Southwestern University of Finance of Economics 2008) 28.

⁷³⁰ Ibid 26.

⁷³¹ Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on Takeover Bids a.5

⁷³² Ibid a.16.

about the price and terms of the hostile offer, and a recommendation of not accepting the offer and provide the reasons;⁷³³ 2) seeking a white knight; 3) the target's board may develop its own alternative transaction such as management buyout.⁷³⁴ Also, the available pre-emptive defensive measures in the UK are similar to that in the US, although shareholders' approval is typically required for most cases such as a defensive recapitalization of the company's debt and capital structure.⁷³⁵ Thus the defenses almost never happen in the UK's market.

It could be presumed that defensive measures could function well in an open market with a shareholder-friendly regulatory environment. To prevent the abuse of these tactics, directors should be loyal to their fiduciary duties and be professional in taking over another company or defending against hostile raiders. Meanwhile, political factors and cultural difference may also have influence on takeover regulation choices. Importantly, the markets in the US and UK are mature, as is the corporate governance experiences within companies. A hostile takeover may not happen to a worthless company. One thing is fairly straightforward: Only a company with a crown jewel needs a pro-active defence tactic in order to deter hostile bidders from attempts to take them over. A company that employs a poison pill alongside a staggered board can also indicate shareholders' will to control the company or their faith in the value of the company shares. Parachutes protect directors, but they can be considered as

⁷³³ Stephen Kenyon-Slade, *Mergers and Takeovers in the US and UK : Law and Practice* (OUP 2004) 696.

⁷³⁴ Ibid 714-715.

⁷³⁵ Ibid 696.

intended to guarantee that directors maximise shareholder benefits given that the directors do not need to consider their own benefits being harmed by a takeover offer. Thus it can be seen that one of the key tenets of these takeover defence measures is preservation of the real value of the target company.

Chapter 6: Takeover defences relating to litigation and other known tactics

Executive summary

This chapter will discuss the use of takeover defensive measures relating to litigation, which is the last kind of takeover defensive measure. This chapter will generally focus on the raising of anti-trust issues in defending hostile raiders. It will additionally discuss the view that raising anti-trust issues can be risky because it may terminate a hostile takeover; if a target company only intends to stall for time, and/or a better offer, this tactic would not be best.

This chapter argues that antitrust tactics are more popular in China because China's anti-takeover system is still at the start of its development, and this tactic may be more easily used by market players in contemporary China as compared with other more complicated shareholding structure related tactics. Detailed discussion about using anti-trust law as a defensive tactic in China will be included in the next chapter as part of the background introduction of China's market.

Also discussed are other defensive litigation measures, such as claiming the hostile bidder did not provide adequate information, (China's information disclosure provision requires further improvement to help reduce inadequate information disclosure issues) or that there might have been criminal activity during the takeover

process (however, raising such issues would only be effective if there genuinely were criminal actions).

Finally, this chapter discusses other tactics, including the people pill, and considers the wide variety of defensive measures. In terms of their evaluation, these tactics will be defined as one of three kinds of takeover defences discussed in chapter 4 to chapter 6, according to that type of measurer's regulation. Consequently, these tactics could be regulated based on the principles of regulating these three kinds of tactics separately.

1. Introduction

Between 1962 and 1980, one third of US takeover cases involved lawsuits.⁷³⁶ During that time, litigation was the most frequently used takeover defensive measure in the US".⁷³⁷ Litigation-related takeover defensive measures are seen as post-bid takeover measures and mainly encompass those lawsuits filed by a target against a bidder regarding the bidder's violation of Anti-Trust Laws, Company Law, the Securities Act or other relevant legislation. These measures can help the target company successfully defend against a bidder's takeover, by winning the case, or otherwise by

⁷³⁶ Liang He, 'Waiguo Falv Fan Binggou Cuoshi dui Zhongguo Qiye Haiwai Binggou de Qishi [Enlightment from the Foreign Anti-takeover Measures to Chinese Companies' Oversea Takeovers]' (*China Business Update*, 23 May 2012).

<http://fec.mofcom.gov.cn/article/zlyj/sywz/201205/1294924_1.html> accessed 10 March 2014 and also in Richard S Ruback, 'An Overview of Takeover Defenses' in Alan J Auerbach (ed), *Mergers and Acquisitions* (University of Chicago Press 1987) 64.

⁷³⁷ Richard S Ruback, 'An Overview of Takeover Defenses' in Auerbach (ed), *Mergers and Acquisitions* (University of Chicago Press 1987) 63, 64.

buying time for the target and reducing the bidder's desire to take over the target due to complicated judicial proceedings and a good amount of litigation cost.⁷³⁸

Target companies typically have one of three reasons for suing the bidder company during a takeover. These are: first, based on the anti-trust restrictions, the takeover would give the bidder monopoly power over a market or specific area; second, information regarding this takeover activity relating to the bidder company or takeover process is inadequate, such that key information has been, or may be, hidden by the bidding company; third, there may have been criminal activity during the takeover process.⁷³⁹ Whichever is the reason in question, the aim of the litigation is to either delay the process of hostile takeover and allow additional bidders to emerge, or else push the bidder company to increase share premiums through the enhanced negotiating power provided by the litigation.

There are two areas of law that could be relevant if either party involved in the takeover desires to buy time using litigation: these are Antitrust Law and Securities Law. Antitrust Law focuses on the healthy development of the whole market, while Securities Law is more focused on certain illegal activities on the part of the bidder company, or on failure by the bidder company to fulfil certain regulatory requirements. For example, almost every takeover system has compulsory regulations

⁷³⁸ Changqing Xu, 'A Study of Legal Issues of Listed Company Anti-Takeover' (Masters Thesis, Fudan University 2008) 16.

⁷³⁹ Hongtao Xu, 'Research Report on Anti-takeover legislation system of the Listed Companies' (2006) <<http://www.szse.cn/UpFiles/Attach/1088/2006/04/19/1624072376.pdf>> accessed 25 February 2014.

regarding responsibilities that apply to a bidding company, such as the disclosure of share holdings, and other certain information disclosures to the public and compulsory tender offer.⁷⁴⁰ Violations of these regulations could be cited by a target company in order to bring a lawsuit against the bidder and try to terminate that takeover activity.

In contemporary China, much of the research about takeover defence measures pertain to anti-trust issues; a few other measures like three kinds of parachutes and white knight defence are familiar to the public. Objective evaluation of anti-trust regulations are therefore important to China's market and research on takeover defence measures still needs to be improved in China. This chapter will therefore mainly focus on issues regarding violation of litigations, providing inadequate information to the target, or even fraud occurring during the takeover process. Other seldom-used anti-takeover measures are not discussed in-depth but will be mentioned

⁷⁴⁰ In the US, according to 17 CFR 240.14d-6, there is a detailed regulation of disclosure of tender offer information to security holders. Also, in China, according to Liang He, 'Waiguo Falv Fan Binggou Cuoshi dui Zhongguo Qiye Haiwai Binggou de Qishi [Enlightment from the Foreign Anti-takeover Measures to Chinese Companies' Oversea Takeovers]' (China Business Update, 23 May 2012). <http://fec.mofcom.gov.cn/article/zlyj/sy wz/201205/1294924_1.html> accessed 10 March 2014; relevant provisions can also be found in Measures for Administration of the Takeover of Listed Companies (2008 Revision) (Measures). In the Measures, article 13 and 14 state that "if the shares whose entitlements are held by an investor and its concerted parties reach 5 per cent of the issued shares of a listed company through the securities transactions at the stock exchange (in article 14, 'by means of transfer agreement'), they shall formulate a report on the alteration of share entitlements within 3 days after the said fact occurs...notify the listed company and announce it to the general public; and they shall not buy or sell the stocks of the said listed company again within the aforesaid term." Article 24 regulates that "when the shares of a listed company held by purchaser reaches 30 per cent of the issued shares of the company through securities trading at the stock exchange, and the purchaser continues to increase the shareholding, it shall adopt the means of tender offer and sent out a general or partial tender offer."

in this chapter by way of supplementary information, since these tactics could also be a choice of the target company and need to be regulated by law.

2. Takeover defensive measures relating to other litigation

1) Inadequate disclosure of information

It could be said that the less information released to the public, the better condition the target listed company is in because investors can only use the information disclosed to evaluate whether shares are worth buying or not. Thus, disclosing relevant information to investors could ensure the equality of all investors in having adequate information to make decisions regarding investment in the listed company. In achieving this adequate information disclosure aim, shareholders' benefits can be protected.⁷⁴¹

Not only should the target company's information be properly disclosed; bidding companies are required to disclose sufficient information as well. The UK requires bidders to disclose key information, such as merger intentions and finance ability.⁷⁴²

⁷⁴¹ Deheng Law Offices and Haitong Securities Research Institute, 'Research on Legislative Issues Related to Mergers and Acquisitions of Listed Companies' (Shanghai Stock Exchange Official Website, July 2003) 3 <<http://www.sse.com.cn/researchpublications/jointresearch/c/plan20030701j.pdf>> accessed 15 February 2014.

⁷⁴² See Peking University Research Group of Guanghua School of Management, *Listed Companies' Takeover Defence Tactics and Relevant Regulations in China* [Zhongguo Shangshi Gongsi de Fan Shougou Cuoshi jiqi Guizhi] (Fudan Press 2003) 169. According to rule 1 section D of the Takeover Code: "(a) An offeror (or its advisers) must notify a firm intention to make an offer in the first instance to the board of the offeree company (or its advisers)." Rule 8.1 requires that: "(a) An offeror must make a public Opening Position Disclosure:

However, scholars have not always welcomed the requirement of disclosure of information. In the US, it is argued that State legislation which forces a bidder to release its information to the target restricts the process of the takeover and prolongs the takeover period. Thus, it gives a target company more time to ask for a higher premium and could lower returns for the acquirer.⁷⁴³

More importantly, inadequate information disclosure also affects the price of shares. The pricing of shares can be seen as the best means of achieving the ideal allocation of resources in a relevant free market; the price of shares also reflects the performance of companies' corporate governance and market effectiveness,⁷⁴⁴ thus pricing shares correctly is a key part of listing on the market. If correct information on the listed company cannot be collected and is not revealed when pricing shares and using certain pricing models,⁷⁴⁵ the final share price cannot properly reflect the real value of the listed company such that investors in the market may run the risk of losses if they are misguided by a share price based on inadequate information disclosure. That

(i) After the announcement that first identifies it as an offeror; and (ii) after the announcement that first identifies a competing securities exchange offeror. (b) An offeror must also make a public Dealing Disclosure if it deals in any relevant securities of the offeree company or any securities exchange offeror during an offer period for its own account or for the account of discretionary investment clients.”

⁷⁴³ Gregg A Jarrell, ‘State Anti-Takeover Laws and the Efficient Allocation of Corporate Control: An Economic Analysis of *Edgar v. Mite Corp*’ (1983) 2 *Supreme Court Economic Review* 111, 129.

⁷⁴⁴ Zhixue Li, *Gongsi Binggou yu Zhengfu Jianguan Zhengce Yanjiu [Research on Corporate Mergers and Acquisitions and Supervisory Policy of the Government]* (Economy & Management Publishing House 2012) 87.

⁷⁴⁵ Certain models to price the share in China can be found in Hai Lin and Yongmiao Hong, ‘New Test of Asset Pricing Models in China’ (2005) <<http://efinance.org.cn/cn/interest/1.pdf>> accessed 12 August 2014 This article introduced some economical models to price shares in China.

is to say, inadequate information disclosure could indirectly infringe the investors' interests in the market. Therefore, claiming information was inadequately disclosed is another possible way of defending against a hostile takeover.

a. Case study

The most famous hostile takeover case in China involved Baoan and Yanzhong in 1993, and started the use of anti-takeover measures.

Qin Guoliang, general manager of Yanzhong Industry, expressed doubt over the legality of Baoan Company's holding stocks of Yanzhong Industry, accusing Baoan of secretly holding Yanzhong Industry's stock which reached 5% for 3 days without reporting to the Securities Regulatory authorities of the State Council or to the stock exchange; nor did Baoan Company notify Yanzhong Industry, which led to the intervention of the SFC for investigation and coordination, and ended with the conclusion that illegal behaviour had occurred during Baoan Industry's acquiring Yanzhong Industry. The shares acquired by Baoan were confirmed to be valid, however, meaning the anti-takeover action by Yanzhong failed.

At the same time, Yanzhong pointed out that the affiliated companies had engaged in some rogue trading during the hostile merger process. Under Chinese law, all shareholders, directors, supervisors and senior managers who hold more than 5 per cent of voting shares in the company cannot sell those shares after purchase within 6

months or purchase back those shares after selling them within 6 months;⁷⁴⁶ in addition, if one does so, all premiums should belong to the company. On 30th September 1993, two companies affiliated with Baoan, who already had more than 5 per cent of Yanzhong's shares, sold 276,000 shares. Accordingly, the CSRC made a final decision confirming that the premiums belong to Yanzhong.⁷⁴⁷

b. Summary

It could be said that this case was the beginning of China's adoption of takeover defence measures. At that time Yanzhong had hired a consultant from Hong Kong to start this takeover defence battle;⁷⁴⁸ in 1993, few listed companies in Mainland China knew about takeover defensive measures. This case also revealed certain legislative defects in China. To be specific, compared with legislation in the UK and US, China's legislation regarding the disclosure of shareholding was less comprehensive. China's regulation only provides obligations for shareholding disclosure by major shareholders, as well as the takeover bidder's obligation regarding information disclosure. Western legislation, however, mandates information disclosure by the management team of the target company, which is undoubtedly a form of protection

⁷⁴⁶ Company Law of the People's Republic of China (1993 revision) Ch.5.

⁷⁴⁷ Wenting Liu, *Research on the Practice of Our Listed Companies' Takeover Defense Tactics* [Woguo Shangshi Gongsi Fan Shougou Shijian de Falv Yanjiu] (Masters Thesis, China University of Political Science and Law 2010) 12.

⁷⁴⁸ Peking University Research Group of Guanghua School of Management, *Listed Companies' Takeover Defence Tactics and Relevant Regulations in China* [Zhongguo Shangshi Gongsi de Fan Shougou Cuoshi jiqi Guizhi] (Fudan Press 2003) 104.

in the interests of the target company's shareholders.⁷⁴⁹ China's omission of this provision, pending further improvement of the Securities Act, is therefore a major defect.

After the emergence of takeover activities in the market, and especially after the case of Baoan and Yanzhong, China did improved relevant legislation, such as Company Law; it also established the Securities Act. However, the protection of shareholders is still insufficient and those regulations have many defects. It is claimed by researchers that false information disclosure is a common phenomenon in China's market, and that the information regarding the financing ability of listed companies is insufficient. Moreover, even if the information were disclosed sufficiently, it could possibly not being disclosed in time,⁷⁵⁰ making it possible to mislead investors or even targets. Data also show that from 2001 to 2011, informed trading's premium was over 80 per cent in all major deals in the market, which implies a huge amount of insider trading occurred in China's market. Along with directors' selectively disclosing information to the public, the fairness of information disclosure cannot be guaranteed in China.⁷⁵¹ Even though China enacted Administrative Measures on Information Disclosure by Listed Companies in 2006 to try to force a change in the market, it did not and cannot

⁷⁴⁹ Erik Berglöf, Mike Burkart, Tito Boeri and Julian Franks, 'European Takeover Regulation' (2003) 18 *Economic Policy* 171, 207.

⁷⁵⁰ Shaoyan Sun and Yang Yu, 'Wanshan Woguo Shangshi Gongsi Xinxi Pilou Zhidu de Jianyi [Suggestions of How to Perfecting Our Information Disclosure Regime of Listed Companies]' (2011) 10 *Economic Review* 103, 103.

⁷⁵¹ Zhengrong Chen and Miaoli Pan, 'Zengqiang Shangshi Gongsi Xinxi Pilou Youxiao Xing [Enhance the Effectiveness of Information Disclosure of Listed Companies]' (2012) 12 *China Finance* 43, 45.

change the situation fundamentally; those regulations are not complimented by the existence of relevant civil or criminal responsibilities if someone disobeys the information disclosure regulation. Thus, inadequate information disclosure problems may exist in the long-term, if the cost of non-observance of relevant regulations is too low.

Consequently, as discussed before, in China's market, there is a high possibility of false information disclosure by the target company or bidder company and with insufficient information, or information that is not promptly disclosed to the public, no one can guarantee that a target company can make the right decision as to whether to defend against a bidder or not. Moreover, there is no detailed liability of compensation applied to unfaithful behaviours.⁷⁵² Hence, with a low cost for the illegal disclose of certain information, even if a target company sued the bidder for inadequate information disclosure, the target still has the risk of becoming the next Yanzhong, and losing control in the end. Thus, claiming the bidding company has not disclosed adequate information is a possible anti-takeover tactic but may not be as effective as expected in China at the present time.

2) Crime (Fraud)

⁷⁵² Yu Su, 'Xiugai Zhengquan Fa Ying Jiada Baohu Touzizhe Quanzhong [Enhance Protections over Investors When Revising Securities Act]' *National Business Daily*, (9 September 2014) <<http://finance.sina.com.cn/stock/stocktalk/20140909/014220238435.shtml>> accessed 10 September 2014.

Sometimes, the target company may sue the hostile bidder due to illegal measures used during the takeover process, and this could be useful, especially for target companies that are not as familiar with other possible hostile takeover defensive measures. Firstly, the target company could sue as an attempt to stop the takeover because of the use of illegal measures by the hostile raider, in which case, the hostile bidder would have to provide evidence to prove its innocence. If this is not possible, the hostile raider will not be able to continue to merge with the target company. Consequently, the directors of the target company could gain additional time to seek other possible measures to defend against the hostile raider. However, not every hostile takeover will involve the use of illegal measures; thus this tactic will only apply to certain cases and cannot be widely used. In the UK, if a target company abuses legal actions in order to prevent a hostile takeover, it might also face a charge of abuse of process⁷⁵³ and may be punished by the Panel. In addition, this measure does not prevent hostile raiders as a pre-bid measure, and thus can only act as a supplement to other takeover tactics, acting instead as a remedy if any illegal activity happens during the merger process. Therefore, it is only pertinent to sue if there actually were any actions in breach of laws. If there were not, it is not a good choice as a takeover defensive tactic.

⁷⁵³ “Abuse of process has been defined as something so unfair and wrong with the prosecution that the court should not allow a prosecutor to proceed with what is, in all other respects”: *Hui Chi-Ming v R* [1992] 1 AC 34, PC.

3. Other takeover defence tactics

Another measure to defend against a hostile takeover could be arguing that the hostile raider's takeover offer has illegal intentions or the takeover process has procedural illegality. For example, in the case of Sihuan Pharmaceutical and Zhonglian Construction Group in 2000, Zhonglian mounted a defence against Sihuan because the price offered was not as high as expected⁷⁵⁴ and Zhonglian sued Sihuan for violation of terms and regulations governing tender offers. The case was accepted by the court and helped Zhonglian buy some time.⁷⁵⁵

Indeed, there are many different kinds of takeover defensive tactics but these cannot all be evaluated and analysed within this single thesis. Thus, only widely used tactics have been discussed in full. However, certain factors exist in common across these tactics, based on which this thesis has categorised them. The takeover measures discussed in this section could be seen as cooperating measures, not typically used for defending against a takeover but could nevertheless have a defending effect in practice. These tactics would work best when used in tandem with other major anti-takeover measures, rather than their being used alone. In regulating these takeover activities, the best choice would be categorising these tactics into one of the

⁷⁵⁴ At that time there was a rumour about the new policy of transferring state-owned shares and legal person shares so Zhonglian presumed the share price would increase after the launch of this policy. See <http://www.people.com.cn/GB/channel3/topic1517/>, there is a lot of news about this topic discussing new policy of transferring state-owned shares, accessed 1 July 2015.

⁷⁵⁵ Peking University Research Group of Guanghua School of Management, *Listed Companies' Takeover Defence Tactics and Relevant Regulations in China* [Zhongguo Shangshi Gongsi de Fan Shougou Cuoshi jiqi Guizhi] (Fudan Press 2003) 143.

three kinds of tactics outlined above and enshrining and enacting the principles of regulating these three kinds of tactics separately.

4. Summary

Certain takeover defensive tactics, such as raising anti-trust issues, or using litigation, make for a good choice to use to defend against hostile raiders - but they may ultimately result in the termination of the hostile offer without giving the target company's shareholders an opportunity to change their mind. Given that China's Anti-trust legislation is not as advanced as legislation in the UK and US, both the hostile raiders and target companies in China do not have extensive experience in dealing with anti-trust issues. In addition, Chinese listed companies are not as familiar with other takeover defensive measures, and raising a monopoly issue might only buy time for targets to find other ways to protect their management power over the company. Consequently, if the relevant authorities do not judge that a merger activity will cause a monopoly issue, the target company could not prevent being merged with the hostile raider without using other practical takeover defence measures or a trusted white knight during the period in which anti-monopoly investigations are conducted.

Furthermore, it should be born in mind that any anti-trust investigation could involve government interference into economic activities. Thus making relevant anti-trust legislation should consider market conditions, and the level of government interference should be well controlled in order to ensure market effectiveness as well as market competitiveness. China's SOEs will not be totally privatized in the short

term,⁷⁵⁶ so it could be seen that certain areas (such as oil and electronic which are key areas to the development of a country) will stay relatively monopolized. This may be wise given their importance. Other industries, however, could be more competitive and government interference should be limited. It could be presumed that in those competitive industries, claiming anti-trust issues exist could be effective in defending against a hostile raider. That said, the use of anti-trust law requires experienced legal workers, as anti-trust issues can be very complicated. As illustrated previously, China has three different authorities charged with resolving anti-trust related issues, and there are rules shared by different regulations as well as a lack of regulations when dealing with anti-trust issues.⁷⁵⁷ Accordingly, the effectiveness of resolving an anti-trust issue cannot be guaranteed. Additionally, anti-trust law should be a tool for the government to regulate and control the market at a macro level, rather than being an anti-takeover tactic. If hostile takeover defensive measures are regulated properly, it could be predicted that anti-trust litigation will only function as a defence in the transitional period, as was the case with the US in previous years. Accordingly, the situation in China whereby focus is largely on the discussion of anti-trust investigations as a defence against a hostile raider should, and likely will, be changed.

Another point to be noted is that all takeover defensive measures relating to litigation - Anti-trust Law or Securities Law – are primarily used to help the target company

⁷⁵⁶ This will be discussed in detail in the next chapter.

⁷⁵⁷ Jiansan Shi and Shiyu Qian, *Comparative Study on Antimonopoly Review of M&A* (Lawpress China 2010) 36.

obtain more time rather than actually terminate the takeover activity. Once the hostile raider offers a higher premium, it may be that shareholders will change their mind and sell their shares. If, however, the shareholders would rather keep control over the target company rather than receive benefits in the short term, raising litigation issues alone is not enough to ensure the hostile raider will fail. Thus, companies need to be familiar with other takeover defence tactics in case the target company loses in court.

Chapter 7: Which system is better for China? A comparative study of US, UK, and Chinese takeover rules

Executive Summary

After discussing the background to two takeover regulatory systems in the US and UK, the differences in markets and legal frameworks in China, and the use of three types of defensive measures, this chapter will finalise the discussion as to what takeover regulatory system is best for China and why.

This chapter firstly discusses the most important part of making regulations - the legislative intent - to find out which legislative intent China is closer to. Initially, it was concluded that the US chose a director-friendly approach to regulate takeover activities because it primarily wanted to help protect the target company's control power; the Delaware Act introduced some anti-takeover measures into states in this respect. Moreover, with the support of a mature market environment and sound supervision and regulation, this system worked well in the US for several years. Additionally, there is a discussion of the UK's system as a shareholder-friendly takeover regulatory system, for the benefit of institutional investors and the long-term good of the market. China shares similarities with the UK in terms of a perspective on takeover activities, in that they are good for the development of China's market. Thus, China chose UK's model of regulation.

Secondly, this chapter discusses the large number of SOEs in China and provides analysis of these SOEs and their continuous reform. It argues that the SOEs were not the obstacles of transplanting UK's regulatory system to China's market. And the SOEs may not be totally privatised in the future. However, if China successfully finishes its reform of the SOEs, they could become good market players. Moreover, this chapter also discusses why China does not use the US's approach: China's young market cannot provide sufficient supportive supervision to guarantee all the minority shareholders could have adequate information from the market if these defensive measures are used and China's market affairs are with lots of government intervention which makes US's approach hard to fit in. Also, raising anti-trust investigation as a defensive tactic in China will be discussed in this chapter for a better understanding of China's market.

Following these discussions, this chapter provides some principles for China's regulation of takeover defensive measures: a guarantee of equal treatment of shareholders, sufficient supervision, market effectiveness, and obedience of the information disclosure principle. At the same time, China also needs to resolve current problems in the market: i. the government intervenes in market activities too much; in the future it should be limited; ii. the protection of all shareholders is not sufficient and needs to be improved; iii. protection for minority shareholders in China is particularly weak, and this problem should be solved.

Finally, this chapter concludes that UK regulatory system is a better choice for China now, but with the development of its markets over time, China may gradually introduce more defensive tactics to ultimately arrive at a mixed-style or otherwise distinctive regulatory system. However, this depends on the power released by the government to the market and sounder supportive factors in the market; China may achieve its goal to have an advanced market and maximise shareholders' interests.

1. Introduction

Based on the discussions in previous chapters, it could be concluded that the regulation of takeover defensive measures is highly reliant on the development of the domestic market and the legislative environment. Research has identified three important factors which may influence the likelihood of hostile takeovers in China; these are shareholding structure, financing structure, and corporate governance structure.⁷⁵⁸ According to Lin, the more concentrated the shareholding structure is in a target company, the less likely a hostile takeover is, because controlling power is concentrated with major shareholders and a hostile offer could easily turn out to be a friendly offer.⁷⁵⁹ In addition, the UK and US have more advanced markets meaning that most companies can be financed from the market directly instead of relying on

⁷⁵⁸ Shufang Lin, *Developments of the Hostile Takeover in China From the Perspective of Law* (Masters thesis, Fudan University 18 April 2012) 21-23.

⁷⁵⁹ Ibid 22.

banks; however, financing from banks is still the primary source to get funding for Chinese companies because of the less developed market in China. Since making a hostile offer requires massive funds on the part of the hostile raider, a high reliance on banks to get funds has a negative effect on the hostile raiders.⁷⁶⁰ Even if a hostile raider successfully makes an offer, it still faces the problem of funds shortage. Thirdly, corporate governance structure may influence the possibility of hostile takeovers. Countries such as the UK and the US have single-tiered board structures⁷⁶¹ without the constraint of the supervisory board, thus hostile raiders have greater opportunities to conduct a hostile takeover because of the absence of external governance.⁷⁶² China's corporate governance is two-tiered which lowers the possibility of hostile takeover. Additionally, the capital market is one of the most important factors that can influence relevant regulations, and China's market is not as advanced as that of western countries. Thus, it is understandable that few scholars are researching hostile takeover defence regulations in China because it seems to be not so urgent a topic.

⁷⁶⁰ Peking University Research Group of Guanghua School of Management, *Listed Companies' Takeover Defence Tactics and Relevant Regulations in China* [Zhongguo Shangshi Gongsi de Fan Shougou Cuoshi jiqi Guizhi] (Fudan Press 2003) 115.

⁷⁶¹ In the US and the UK there are only boards of directors in the corporate governance system; however, in some other countries, such as Japan, there are two-tiered corporate governance structures that have both a board of directors and a board of supervisors.

⁷⁶² Shufang Lin, *Developments of the Hostile Takeover in China From the Perspective of Law* (Masters thesis, Fudan University 18 April 2012) 22-23 Also, companies in the western markets can be directly financed from the market and the board of directors have the remit of managing and supervising the company, so external governance is relatively weak compared with companies that have individual supervisory boards. If a board of directors represents bad management of a company, the absence of a qualified supervisory board would likely result in the failure of that company's business. Consequently, the share price might drop in the market, which could attract some hostile raiders. Thus, it could be said that the single-tiered corporate governance structure prevalent in western countries makes hostile takeovers more likely.

However, in recent years, the number of listed companies in China's market has increased dramatically, and the securities market is developing as well. China is continuing the reform of shareholding structures, and it could be predicted that the market will become as advanced or even more advanced and attractive to investors - including hostile raiders - along with the resolution of shareholding problems. Thus, relevant hostile takeover regulations are still necessary for China to prepare for the maturity of her market.⁷⁶³

This chapter, will discuss which legislative system China could adopt, and why, based on the analysis of the previous chapters. This does not mean that this chapter will suggest China directly copy another system; it will still need to enshrine certain unique principles regarding the hostile takeovers within its own market.

2. Legislative intent and China's background

In the contemporary Chinese market, not all takeover defensive tactics are prohibited. Legalised measures include the staggered board, the white knight, and pursuit of litigation. However, other defence strategies are prohibited. The golden parachute, scorched earth, and green mail are all disallowed. In addition, some anti-takeover measures are neither clearly legalised nor strictly prohibited, such as the Pac-man

⁷⁶³ Benzhao Zhang, Yanrong Wang and Zhixiong Zhu, 'Poison Pills in Western Target Companies and the Inspirations to China [Xifang Mubiao Gongsi Fan Shougou Duwan Jihua ji Dui Woguo de Qishi]' (2007) 1 *Modern Management Science* 67,68.

defence, convertible corporate shares, and the employee stock ownership plan.⁷⁶⁴

Those takeover defences were not invented in China and they have been learned from western markets. For example, white knight defence and pac-man defence are all allowed in China's market. Thus, finding out in which kind of market these tactics could work and why some measures are prohibited would be helpful to set some principles to follow in the future.

Laws are made against certain historical backgrounds and with considerations of social and cultural environments. Therefore, when discussing China's takeover defence regulations, the legislative intent and backgrounds must not be ignored. Indeed, the intention behind making a law reflects which kind of regulatory system China seeks, and the social and/or culture background of the country could decide whether the chosen regulatory system can fit China's market. This section will therefore clarify the intention of regulating takeover defensive activities in China first, provide an analysis of China's market environment, and then discuss which regulatory system China should adopt and how it should regulate takeover activities.

Since China has drawn reference from the advanced western legislative systems to regulate its market, an analysis of the legislative intentions and backgrounds of western jurisdictions should be provided to find out under what conditions and against

⁷⁶⁴ Wenxia Zhou, *The Value Analysis and Legislation Selection of Anti-takeover Actions - Concurrently Discuss the Application of Anti-takeover Measures in China* (Masters thesis, Jilin University 2008) 33.

which backgrounds certain legislation was enacted. At the same time, this analysis of western systems could help with the discussion of their applicability to China.

China started to establish takeover regulatory systems for listed companies from 1992 when it issued *Provisional Measures of Shenzhen Municipality for Supervision and Control of Listed Companies*, and in 2002 produced the first version of *Takeover Measures*.⁷⁶⁵ The first US legislation on the takeover of listed companies in its market emerged in 1968 when the Williams Act was enacted.⁷⁶⁶ The UK's first uniform regulation of takeover activities was published in 1968, also much earlier than China.⁷⁶⁷

Moreover, as discussed in the preceding chapter, between the 1960s and 1980s US companies frequently used litigation to defend against hostile bidders, either to delay a takeover or raise the premium; thus it could be said that contemporary China is in a relatively similar position now. China's market has been developing for approximately 30 years and many takeover defensive measures are not familiar to the Chinese listed companies - except for litigation. Also similar is an awareness of listed companies that they can fight against a hostile bidder, but a lack of knowledge and

⁷⁶⁵ Deheng Law Offices and Haitong Securities Research Institute, 'Research on Legislative Issues Related to Mergers and Acquisitions of Listed Companies' (Shanghai Stock Exchange Official Website, July 2003) 3 <<http://www.sse.com.cn/researchpublications/jointresearch/c/plan20030701j.pdf>> accessed 15 February 2014.

⁷⁶⁶ John Armour and Jr. David A. Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? -- The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 *Georgetown Law Journal* 1727, 1754.

⁷⁶⁷ *Ibid* 1760.

experience as to how to do this. Resultantly, litigation is often the first thing these companies would think to use. Few Chinese scholars had researched defensive measures other than litigation related to antitrust issues. Thus, China's takeover legislation lagged behind other nations. This section will discuss when and why the US and the UK started to establish and enhance relevant takeover regulations and provide market backgrounds for the analysis of uses of those measures.

1) The United States: Historical legislation and market background

In the US, there was a takeover boom starting in the 1980s in Delaware, when lots of corporations started to takeover. Before that time, the economy in Delaware was not as good as that of other states, so the state government tried to use a favourable tax policy to attract more investors, which proved to be very effective. From the early 1980s, many corporations moved to Delaware because of this tax policy and sounder supportive regulations, which made Delaware a good example for other states and even other countries to learn from.⁷⁶⁸ At that time, the increasing number of corporations in Delaware made the state a good place to do business; however, the emergence of takeover activities also made companies in Delaware more attractive to bidders, friendly or hostile. Later, the invention of takeover defensive measures such as the poison pill and staggered board helped potential target companies gain more

⁷⁶⁸ Guhan Subramanian, 'The Disappearing Delaware Effect' (2004) 20 The Journal of Law, Economics & Organization 32,59.

bargaining power to protect their control of the company. Proponents argued that the existence of takeover defensive measures also allowed the target company more bargaining powers even in friendly deals.⁷⁶⁹ However, some research has shown that anti-takeover tactics reduced the differences between Delaware companies and non-Delaware companies, the number of takeover activities and even the value of Delaware companies relative to those of non-Delaware companies.⁷⁷⁰

Thus, the US' route to regulate anti-takeover tactics was based on the success of market environment and relatively sound supportive supervision and regulations. Even though the use of takeover defensive tactics reduced the number of takeovers in the US, this had advantages from the perspective of long-term interest of the target company and the development of the market as not every takeover activity would be helpful to the target company or the bidder company. Also, as discussed in the third chapter, successful attempts to attract investors or improve the market could occur, but that does not mean that success would be replicated in every state or country with different background corporation laws.

⁷⁶⁹ Guhan Subramanian, 'Bargaining in the Shadow of Takeover Defenses' (2003) 113 *The Yale Law Journal* 621, 622.

⁷⁷⁰ Guhan Subramanian, 'The Disappearing Delaware Effect' (2004) 20 *The Journal of Law, Economics & Organization* 32, 59-49. According to Subramanian's research, the value of Delaware firms used to be statistically significant relative to non-Delaware firms between 1991 and 1996 but after 1996 that difference disappears: this may be caused by the emergence of anti-takeover tactics.

It was reported in the 1990s that 40 per cent of the outstanding equity of US corporations was held by the institutional investors.⁷⁷¹ Based on the “active investors” hypothesis, the involvement of institutional investors may have reduced the numbers of takeovers, as they prefer long-term interests for their investments.⁷⁷² Thus the reduced number of takeovers may not be a result of the emergence of takeover defensive tactics alone; the increasing number of institutional investors also contributed to this phenomenon. In addition, it cannot be said that a reduced frequency of takeovers is necessarily harmful to the development of a market. On the contrary, it may be helpful, if weak market players are taken over by competitive ones and the remaining companies perform very well.

Furthermore, shareholder and directors’ struggles in the US provides evidence of the relevance of certain legal environment.⁷⁷³ In effect, a conflict between the shareholders and directors is highly possible. However, in the US, the self-restricted regulations and related supervisory regulations of the state and federal governments support the US’ director-friendly takeover regulation style, yet protect the shareholders at the same time. It could be inferred that US legislators chose this system based on consideration of the legislation environment as it was at the time it was devised; however, this system is still working for the US market now.

⁷⁷¹ Anup Agrawal and Gershon N. Mandelker, ‘Shark Repellents and the Role of Institutional Investors in Corporate Governance’ (1992) 13 *Managerial and Decision Economics* 15, 15.

⁷⁷² Rahul Kochhar and Parthiban David, ‘Institutional Investors and Firm Innovation: A Test of Competing Hypotheses’ (1996) 17 *Strategic Management Journal* 73, 82.

⁷⁷³ James F. Ritter, ‘Unocal Corp. v. Mesa Petroleum Co.’ (1986) 72 *Virginia Law Review* 851, 852.

In sum, the evidence tends to support the view that the allocation of powers to directors in the US increased the bargaining power of management in the event of a control bid, to the detriment of shareholder wealth.⁷⁷⁴ At the same time, this appears to reduce the frequency of takeover bids significantly but does not seem to improve the expected value of shareholder gains in those takeover contests that do occur.

Overall, these considerations suggest that the shareholders' ability to police management through the enforcement of contracts is imperfect, although far from non-existent.⁷⁷⁵

This is surprising and leads to the conclusion that the amendments do not have a significant positive effect on minority shareholder wealth. A possible reason for this is that, if antitakeover amendments make takeover bids more costly – as they must if they are to have significant deterrent effects – and if the takeover market is competitive in their absence, then the amendments may make some any-or-all bids too costly to carry out. In this case, the bidder's alternatives will be to abandon a control attempt altogether or to attempt to gain control through the use of a more

⁷⁷⁴ In the US, the primary feature of its corporate law is its giving managers primary powers to make important corporate decisions, including those pertaining to takeover defensive actions. Further details about US corporation law features can be found in chapter 6 of David Kershaw, *Company Law in Context: Text and Materials* (OUP 2009) and according to an decision made by Delaware Court in case *FLI Deep Marine LLC v McKim*, No4138-VCN, 2009 Del Ch LEXIS 56 (Del Ch Apr 21 2009) at 6, the judge held to this principle to allow managers decision-making power over corporate affairs.

⁷⁷⁵ John Pound, 'The Effects of Antitakeover Amendments on Takeover Activity: Some Direct Evidence' in Gaughan (ed), *Readings in Mergers and Acquisitions* (Blackwell 1994) 327, 328.

coercive, partial bid. The latter alternative is the very strategy that anti-takeover amendments militate against, according to their proponents.⁷⁷⁶

2) The United Kingdom: Different legislative intent and regulatory approach from the US

The UK has a different takeover regulatory system from the US and has influenced most of the other EU countries.

As a matter of fact, there are lots of institutional investors in the UK, for whom the UK intended to provide a beneficial regime. Additionally, given that institutional investors seek long-term interests and thus are not inclined to stay in a market with lower levels of protection, the UK designed a takeover regulatory system with strong protection of the shareholders' interests by giving shareholders decision-making power over defending against hostile takeovers.⁷⁷⁷

The basic principles that should be included in good corporate governance are transparency, accountability, fairness, responsibility, and good regulations.⁷⁷⁸ Hence, the UK law included the fiduciary duty of the management team, which requires management to act *bona fide* in the best interests of the company and to act with

⁷⁷⁶ Ibid 324.

⁷⁷⁷ Rule 21.1 The Takeover Code (Eleventh edition) 2013.

⁷⁷⁸ Colin Law and Patricia Wong, 'Corporate Governance: A Comparative Analysis Between the UK and China' (2005) 16 ICCLR 350, 351.

proper purpose.⁷⁷⁹ There are also a large percentage of minority shareholders in the UK. To protect minority shareholders in order to achieve market fairness, giving shareholders the right to decide whether to accept a bidder's offer is appropriate.⁷⁸⁰ Thus the UK chose a sensible but different regulatory system than the US for its own market so as to meet the requirements of both institutional investors and the long-term development of its market. More importantly, the UK adopts the view that takeover activities help improve the market so its rules were intended to promote the frequency of takeover activities by giving the decision-making power to shareholders. Moreover, in the UK a takeover activity is preceded in a relatively short time according to the timetable of the Takeover Code⁷⁸¹ and many takeover defence tactics are prohibited⁷⁸² in the UK, helping to shorten the time takeover activities require as well. The UK market is not perfect, but few scholars criticize its regulatory system, which banned takeover defensive measures and thus could be seen as the right choice for UK regulators.

3) China: A distinct market from the UK and US but with similar legislative intent as the UK

Both the US and UK regulated their markets with certain intentions in mind, given the features of their markets. The main reason the UK chose a different regulatory system from that of the US was because of its different regulatory philosophy. Thus,

⁷⁷⁹ The directors' duties in the UK are regulated in s.171-177 of Companies Act 2006.

⁷⁸⁰ The Takeover Code (Eleventh edition) 2013 Rule 21.1.

⁷⁸¹ The Takeover Code (Eleventh edition) 2013 Rule 31.

⁷⁸² The Takeover Code (Eleventh edition) 2013 Rule 21.

regulatory philosophy can make great difference in the future of market regulation. Both the UK and the US have a dispersed shareholding structure and minority shareholders in the market, but their philosophies are different: the US's hostile takeover regulatory system was started from Delaware and aimed at using regulation to the listed companies in a certain state, so it empowered the directors' decision-making regarding takeover defences; the UK gave this power to shareholders because of institutional investors, and because regulators believed takeovers would be helpful for the development of the market.

China's capital market ranked third, globally, for 20 years,⁷⁸³ and it has achieved this level in a very short time compared with how long – decades; a century - it took many mature markets to achieve.⁷⁸⁴ This rapid development was not unaccompanied by certain defects and a lack of regulations. However, in China, the market structure is totally different to the UK or the US, with a highly concentrated shareholding structure and few institutional investors when China first began regulating takeover activities. China shared a similar view of takeover activities to the UK, in that takeover activities can be helpful for the development of China's market.⁷⁸⁵ Thus this

⁷⁸³ Juan Chen, *Regulating the Takeover of Chinese Listed Companies: Divergence from the West* (Springer 2014) 8.

⁷⁸⁴ China Securities Regulatory Commission, *China Capital Markets Development Report* (China Financial Publishing House, 2008) preface.

⁷⁸⁵ China keeps making efforts to promote takeover activities to improve market effectiveness and also trying to improve the audit process of CSRC to make it even more efficient. It is also argued that takeover activities could help the listed company to improve the performance in the market and expand its business. And through the reforms of the government authorities, it could be seen that the attitude of China's government towards takeover activities is really positive. See Securities Times, 'Guli Binggou Chongzu Xianjin Fenhong Huigou Gufen [Encouraging M&A Cash Dividends and Shares Buy-back]'

could be taken as a key reason why Chinese legislators partially followed the UK's approach to regulate China's market even if this system may not have totally fitted China's market. Among all the differences between China's market and the UK's market, the shareholding structure matters the most when considering takeover regulation. As discussed in the previous chapter, China's shareholder structure is highly concentrated and there are a large number of SOEs holding a good amount of capital in the market. Given that the state is the only shareholder of these SOEs, it is possible that the state is affecting the decision-making process of the many listed companies that are directly controlled by the SOEs and indirectly controlled by the state. Consequently, as the key difference between the UK's hostile takeover regulation and the US's is the delegation of decision-making power, the existence of those SOEs could be problematic when deciding which way China will go – along the lines of the UK, or the US.

3. The large number of State Owned Enterprises (SOEs) in China

Before discussing and analysing which regulatory system is better for China, an important factor should be clarified: the existence of a large number of State Owned Enterprises. For many years, almost all research on Chinese economics, the stock market or corporate governance regulation has mentioned China's SOEs because these held a large volume of stock and were able to control China's economic

(1 September 2015) < http://www.sac.net.cn/hyfw/hydt/201509/t20150901_125307.html > accessed 2 May 2016.

development. However, in recent years, certain defects with SOEs have become apparent, such as their inefficiency and lack of competition. In this section, a clear illustration of SOEs in China will be provided, followed by a discussion as to whether SOEs are as problematic as has been claimed, and then a conclusion as to whether China should follow western countries and privatize as many SOEs as it can.

China has a large number of SOEs in its capital market because of its socialist nature and the uncompromising principle of “maintaining the leading status of SOEs”⁷⁸⁶ that was adhered to when China started to establish and improve its capital market. After years of development, the existence of the SOEs is a key point when discussing China’s economy, as they are an important element of China’s capital market. In case of any unexpected special circumstances, China’s government has the potential to use state power to help SOEs resolve issues, which could be seen as a violation of market rules, with SOEs competing unfairly with other companies in the market due to this support.

In addition, SOEs control a large amount of capital in China’s market and they have the controlling power over many listed companies in the market. The table below illustrates how much capital is owned by China’s listed SOEs:

⁷⁸⁶ Zhonggong Zhongyang Guanyu Guoyou Qiye Gaige he Fazhan Ruogan Zhongda Wenti de Jueding[Several Major Resolutions by the Central Committee of the CPC on the Reform and Development of State Owned Enterprises], The Fourth Plenary Session of the 15th Central Committee of the CPC, Sep. 22 1999.

Table: Listed SOEs as a significant force in Chinese securities market

Year	Number	Percentage (%)	Market capitalisation (US\$100 million)	Percentage market capitalisation (of)
1995	211	67.8	3,867	N/A
1999	626	67.8	29,974	N/A
2003	928	73.3	45,255	N/A
2005	828	60.0	30,423	50.8
2007	936	61.7	400,409	50.6
2009	777	46.4	242,662	40.9
2010	1093	53	273,571	71

Source: Organisation for Economic Co-operation and Development (OECD)⁷⁸⁷

⁷⁸⁷ OECD Working Group on Privatization and Corporate Governance of State Owned Assets, 'State Owned Enterprises in China: Reviewing the Evidence' (2009) <http://www.oecd.org/dataoecd/14/30/42095493.pdf> referenced from Juan Chen, *Regulating the Takeover of Chinese Listed Companies: Divergence from the West* (Springer 2014) 10.

Although this table shows that SOEs hold large amount of stock in the market, it does not contain anything in terms of SOEs' effectiveness/efficiency, or provide any negative evidence regarding their impact on the market. SOE reform started in the 1970s while China was still implementing a planned economy,⁷⁸⁸ and in the decades since that time, the SOEs have continued to change. Even though it cannot be said that SOEs do not have any drawbacks now, there are still opportunities for the SOEs to be improved rather than to be abolished.

There may be some confusion about State Owned Enterprises for western researchers, following some harsh criticism from Chinese scholars, some of whom support the idea of abolishing SOEs and letting them privatize as in western countries, in order to make them compete equally with other market players. However, this thesis, does not take this perspective, and argues that to certain extent, the existence of the SOEs is still important for China's economic development in contemporary society.

As introduced and discussed in Chapter 1, SOEs are experiencing continual reform in China and the number of the SOEs has been significantly reduced over recent years. Indeed, SOEs could be as competitive as other listed companies if the current Chinese leadership successfully finishes SOE reform. SOEs might always attract criticism because of China's administrative systems, not the SOEs themselves. If and when China minimizes intervention in SOE management and limits the government's

⁷⁸⁸ Dongtao Zou (ed) *Report on China's Economic Development and Institution Reform No.1: China 30 Years of Reform and Opening-Up* (Social Sciences Academic Press(China) 2008) Chapter 12 available at <http://theory.people.com.cn/GB/68294/131889/134330/index.html> accessed 1 November 2014.

power to get involved in market affairs, SOEs would not be a problem while transplanting successful western-style legal systems to China.

4. Anti-trust law as a defensive tactic

First, it should be acknowledged that a highly-concentrated market is harmful to the public interest because: 1) the more concentrated a market is, the higher product or service prices will likely be, which might be unfair for consumers, as it would not be that high in a competitive market; 2) the fewer competitors in the market, the less lively the market. Because of the highly concentrated structure of the market, the monopolist will likely be reluctant to undertake further research or development meaning that the technology or the level of service will not advance. This effect is also harmful to the public interest. Given the long-term impact monopoly issues can have on the market, the market is in need of certain level of government intervention in takeover activities; there may be no one else to judge whether takeover activity should be terminated because of the possibility of monopoly.

Anti-trust legislation is extremely important in ensuring the economy goes as well as it should by setting rules to prevent business monopolies in certain area, instead helping the market to be competitive, in the interest of consumers. If the operation in certain areas of the market is highly concentrated, merger and acquisition activities could cause further concentration, violating anti-trust law, and should be halted.⁷⁸⁹

⁷⁸⁹ Deheng Law Offices and Haitong Securities Research Institute, 'Research on Legislative Issues Related to Mergers and Acquisitions of Listed Companies' (*Shanghai Stock Exchange Official Website*,

Consequently, anti-trust law could function as a takeover defence tactic for a target company since it could bring to a halt an unsolicited takeover offer by raising anti-trust issues to relevant bodies able to terminate takeovers. Anti-trust law, used as a takeover defensive tactic, is the most frequently discussed anti-takeover measure in China. It was frequently used in the US in the 1960-1970s, but has not been encouraged in western countries recently.⁷⁹⁰ It should therefore be considered why China's market is using a tactic that was popular more than 50 years ago but is now less frequently seen in western countries.

Government should play a role in protecting public interest in order to keep stability in society; a sound anti-trust regulatory system is crucial in order for the government to develop the market. It is therefore very reasonable that the government should reserve the right to stop takeover activity for the good of the public. Moreover, a government's well-advised guidance on activities in the market could decide the role of economic regulations to the anti-takeover issues of the listed companies. That is to say, the relevant government department could initiate enhanced legislation to provide a sound regulatory system and rational supervision of takeover-related issues in the market, to protect all participants' interests. In this way, the government could engender a better economic atmosphere for the market and help push market

July 2003) <<http://www.sse.com.cn/researchpublications/jointresearch/c/plan20030701j.pdf>> accessed 15 February 2014.

⁷⁹⁰ Patrick A. Gaughan, *Mergers, Acquisitions, and Corporate Restructurings* (5th edn, John Wiley & Sons 2010) 227.

development.⁷⁹¹ Accordingly, government intervention will also be evaluated when considering anti-trust litigation as a takeover defence tactic.

Encouraging a target company to raise anti-trust issues to defend against a hostile bidder could be seen as intervention in economic activities by the government; there should therefore be some limitations on the scale of the government's power to intervene in this manner. To some extent, a principle of economic law applies here, regulating anti-trust issues during the merger and acquisition process: the principle of moderation. This means there are rules to be referenced but that those rules will not constrain the development of the market and could instead provide a relevant "free market" for participants to do business.⁷⁹² Governmental interference should be regarded as necessary in monitoring the market to ensure healthy development; however, the government should not be allowed too much power, which might be abused, and could result in a market with too many obstacles relative to the market's development.

That is not to say that regulating takeover activities is an entirely political issue. It is aiming at solving market concentration issues, but the decision of whether a takeover could cause this problem is made by the government. That is to say, the intention of financial regulations is to provide a competitive market for consumers' benefit, but the government plays the main role in prohibiting monopoly activities. Ultimately, the

⁷⁹¹ Junjie Zhang, *Research on Legal Issues of Takeover Defense Tactics of the Listed Companies* (Masters Thesis, Sichuan Academy of Social Sciences 2011) 28.

⁷⁹² Changqi Li, *Economic Law* (Law Press Beijing 2008) 79.

interference of a government in market activities should be limited, yet still functional in terms of executing its duty. The government's decision-making power is provided by anti-trust regulation; if in certain legal systems a government is given too much power in deciding a takeover activity, the intended function of this takeover defence can work. Markets need relevant regulations to reduce monopoly issues, and the regulation needs to allow for the resolution of these issues via relevant authorities. If regulation is similar in one market to another but the structures of authorities are different, the application of these regulations will be different. This is what happened in China as compared with western countries: China's anti-trust law could be said to be advanced because it drew reference from the most advanced legislative experience, but the authorities in China and in western countries do not have similar levels of government interference. The structures of China's authorities are more complicated than western countries' and the Chinese government has too much power over these affairs, as all authorities are government departments.

Due to the globalisation of markets, takeover activities may involve participants from all over the world, not only from the domestic market. Thus, regulations regarding takeover activities should also consider foreign investors. If the success of those takeover activities would cause competition issues, the process should be restricted by the Anti-trust Law. In the UK, the process is regulated by Competition Law, and the Companies (Cross-border Mergers) Regulations 2007 and Directive 2005/56/EC⁷⁹³ if

⁷⁹³ Practice statement No.18, The Takeover Code (Eleventh edition) 2013.

there is a significant cross-border element; in the US, it is regulated by Anti-trust Law - as it is in China. This section, it will not distinguish foreign from domestic bidders in China's market in discussing the impact of raising monopoly issues as a defensive measure, because, in China, neither type of investor would be in a different position when relative to the anti-takeover effect of this measures. The point of mentioning foreign investors here is to act as reminder of the situation in China; more and more scholars prefer to focus on anti-trust law to defend against hostile takeovers rather than alternative methods, which may be a result of China's market becoming more attractive to foreign investors. However, for the healthy development of Chinese market and the development of the Chinese listed companies, research on takeover defensive measures should be more comprehensive, and not only focus on one area which seems to be popular at present. Consequently, in this section, the discussion of anti-trust issues seeks to fill this research gap and tries to provide a comprehensive consideration of anti-trust law as a takeover defensive tactic.

1) Experience in western countries

In comparing western and Chinese anti-trust legislation, a brief introduction to the US, UK, and Chinese systems would be prudent. Two of the most developed countries in the world, the US and the UK have the extremely advanced legislation systems. The US has an even longer history in regulating anti-trust movements than the UK,⁷⁹⁴ whilst the UK's competition legislation has its own unique elements that differ from

⁷⁹⁴ The first piece of anti-trust related legislation of the US was drawn up in 1887, and the UK passed its first competition law in 1948. These will be discussed below.

the US: since the UK is a member of the EU, it incorporates some EU regulations in its own competition law. China has more and more market-based economic activities in recent years, but only developed its own regulations late in the 2000s, and is therefore still in its infancy.⁷⁹⁵

2) China's circumstances

In China, the legal basis of listed companies to use Anti-trust law as a weapon to defend against hostile takeover is enshrined in article 38 of the Anti-trust Law which states that “any entities or individuals may tip off any suspicious monopolistic conducts to the Anti-trust Law Enforcement Authorities and the Anti-trust Law Enforcement Agency shall keep the informer confidential.”⁷⁹⁶ As China has a young market compared with the UK and US, its lack of knowledge and experience could be an issue for market players, and their use of other defensive tactics such that it could be easier to ask for an anti-trust investigation as a defence against a hostile bidder.

China's anti-trust drew on EU Competition Law. Even though it is thought that EU Competition Law and US Anti-trust Law will become more and more similar over time, there are key distinctions between the primary goals of each body of legislation that means they will never be identical. The EU's competition regulations mainly aim at helping to promote European integration, while the US's antitrust law was born in

⁷⁹⁵ Kai Liu and Hasani Mohd Ali, 'Hostile Takeovers and Anti-Monopoly Regulations in China and Malaysia with Special Reference to US and UK Experiences' (2014) 22 *Pertanika J Soc Sci & Hum* 293, 293.

⁷⁹⁶ Article 38, Anti-trust Law of P.R.C.

an already uniform market, which was more focused on restrictions against monopolists. The EU's political objective is similar to the Chinese regulators' intention to make laws that can help the construction of a uniform market in China.⁷⁹⁷ In addition, it is said the US's antitrust legislation only protects "competition", and not "competitors" within the market, such that other issues are not to be considered by legislators. In China, public interest and the national economy are both factors, which legislators will consider when dealing with antimonopoly legislation, so as to secure the healthy development of China's market.⁷⁹⁸ Accordingly, EU's antitrust legislation is more comparable with China's than the US'.

That said, China differed from the UK's voluntary merger control to make reporting mandatory, with a stricter policy for the review procedures. Anti-monopoly merger reviews are compulsory for certain merger activities, so Chinese anti-trust law is broader than the EU rules in this respect.⁷⁹⁹

The anti-trust monitoring system in China is more complicated than that in the UK or US. This is illustrated below:⁸⁰⁰

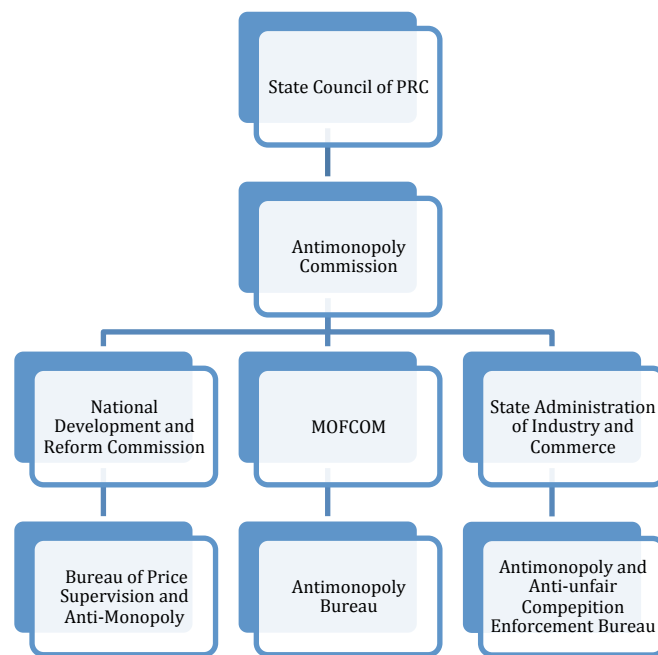
⁷⁹⁷ Tao Sun, 'Inspirations from the EU Competition Law to China' (28 April 2002)

<http://www.hicourt.gov.cn/theory/artilce_list.asp?id=95&l_class=3> accessed 15 May 2014.

⁷⁹⁸ Jiang Feng, *Law Practice of China's Antitrust of Merger and Acquisition - The Review of Shenzhen Lawyers* (Lawpress China 2012) 148.

⁷⁹⁹ According to a. 21 of Anti-monopoly Law of P.R.C., if the business operators reach the threshold of declaration, it should declare in advance, and otherwise they shall not implement the concentration.

⁸⁰⁰ This form is referenced from Jiang Feng, *Law Practice of China's Antitrust of Merger and Acquisition - The Review of Shenzhen Lawyers* (Lawpress China 2012) 97.



As can be seen in the form above, there is no single independent authority in charge of solving antimonopoly issues; different bureaus have different functions to regulate the market. Specifically, the first level of the monitoring system is the Antimonopoly Commission (AC) of the State Council of the PRC. This committee regulates the market at a macroscopic level by establishing anti-monopoly policies, investigating and reporting the competition situations of the market, and guiding antimonopoly enforcement work. There are then three different bureaus in charge of different departments of the State Council, which each have different functions to enforce regulations set by the AC. The Antimonopoly Bureau of MOFCOM is chief amongst these as the office of the AC is set within it.⁸⁰¹ The Antimonopoly Bureau is in charge of taking anti-trust investigation and dealing with international antimonopoly

⁸⁰¹ Ibid 96.

lawsuits.⁸⁰² The other two authorities are not as familiar as the Antimonopoly Bureau of MOFCOM to western researchers probably because they mostly deal with domestic mergers. These are the Antimonopoly and Anti-unfair Competition Enforcement Bureau (AACEB) of the State Administration of Industry and Commerce (SAIC), and the Bureau of Price Supervision and Anti-monopoly (BPSA) of the National Development and Reform Commission (NDRC). AACEB is responsible for investigating monopoly agreements, abuse of dominant market position, and abuse of administrative power over antimonopoly affairs. The BPSA focuses on solving monopoly issues about price control.⁸⁰³ Therefore, the CMA is unlike the UK in that it does not exercise all antimonopoly issues in a uniform body; this has the effect of making the enforcement system less clear.

In addition, the authorities are not independent of government. Thus, it could be argued, Chinese antimonopoly administration authorities are executing governmental will, instead of purely considering the interests of the market and the consumer. Contrariwise, it could be refuted that antimonopoly legislation itself reflects the government's will because anti-monopoly regulation is a combination of political will and legal order. Thus no antimonopoly legislation is separate from governmental will, and so China is simply stricter in ensuring that competition issues fall under state control. Too much state interference is not helpful for the development of the market,

⁸⁰² Antimonopoly and Anti-unfair Competition Enforcement Bureau, 'Antimonopoly Commission of State Council and Antimonopoly Enforcement Agencies' (27 September 2008)

<http://www.saic.gov.cn/fldyfbzdjz/zflt/200909/t20090927_71218.html> accessed 15 May 2014.

⁸⁰³ Ibid.

but it is reasonable for legislators to be conservative in making laws for the emergent Chinese market. That said, things will need to change in the future as the more the state interferes in market activity, the less healthily the market will grow. The development of a more open and free market has been the trend in recent years, and China's antimonopoly legislation is also predicted to change during this process.⁸⁰⁴

At present, antimonopoly litigation may be interfered with pursuant to the government's will. Whether a hostile takeover would be approved by authorities or not seems to be totally under the government's control, and neither the target nor the bidder can drive the result. Accordingly, it could be suggested to the target that, if the target would never consider accepting the hostile offer, helping relevant authorities approve the possibility that a monopoly may be created is not a good choice, because once the investigation is cleared, the hostile takeover is terminated even if the hostile bidder offered a higher premium. In China, like in the UK and US, there are some remedies for disagreements about antimonopoly investigation results: the disagreement can be reviewed by administrative authorities or resolved by lawsuits, for example.⁸⁰⁵ However, it seems to be difficult to change the result because administrative authorities are also exercising governmental will.

⁸⁰⁴ This thesis, will not recommend how antimonopoly law will change as it is not the main focus of this research. However, if the antimonopoly law does change, the impact on hostile takeover defences will bear consideration.

⁸⁰⁵ Jiang Feng, *Law Practice of China's Antitrust of Merger and Acquisition - The Review of Shenzhen Lawyers* (Lawpress China 2012) 322.

Furthermore, to better illustrate the process of how the Chinese authorities actually determine competition issues, it is helpful to provide an introduction of the competition investigation in brief in China. In fact, China's Anti-trust Law gives the power of monitoring the market about monopoly issues to the Anti-monopoly Commission⁸⁰⁶ but it detailed the process of conducting competition investigation in Measures for the Undertaking Concentration Declaration (MUCD) and Provisions of the State Council on the Standard for Declaration of Concentration of Business Operators (Provisions). According to the Anti-trust Law, "no business operator with dominant market position may abuse its dominant position to eliminate or restrict competition",⁸⁰⁷ and once a takeover activity would have the possibility to make the business operator able to exert a decisive influence on other business operators, the business operator should file a concentration declaration to the Anti-monopoly Law Enforcement Agency under State Council.⁸⁰⁸ Meanwhile, the authority has 90 days to make a decision whether the takeover could continue or not.⁸⁰⁹ Moreover, according to the Provisions, only a concentration of undertakings reaching one of the following thresholds need be notified to the authority first, otherwise the concentration is not unlawful:

"(1) the combined worldwide turnover of all the undertakings concerned in the preceding financial year is more than RMB 10 billion yuan, and the nationwide

⁸⁰⁶ Anti-monopoly Law of P.R.C. a.9.

⁸⁰⁷ Anti-monopoly Law of P.R.C. a.9.

⁸⁰⁸ Anti-monopoly Law of P.R.C. a.21.

⁸⁰⁹ Anti-monopoly Law of P.R.C. a.26.

turnover within China of each of at least two of the undertakings concerned in the preceding financial year is more than RMB 400 million yuan; or (2) the combined nationwide turnover within China of all the undertakings concerned in the preceding financial year is more than RMB 2 billion yuan, and the nationwide turnover within China of each of at least two of the undertakings concerned in the preceding financial year is more than RMB 400 million yuan.”⁸¹⁰

However, according to the MUCD, before the business operator officially notifies the authority about the takeover activity, the business operator can file an application for consultation with MOFCOM in respect of issues relevant to the takeover.⁸¹¹ Even if the participants of the takeover activity do not reach either of the thresholds above, the business operator can still voluntarily submit a notification filing to MOFCOM to review this takeover activity. At the same time, according to Measures for the Undertaking Concentration Examination, the business operator can recall its notification of competition investigation to the MOFCOM before the investigation is started and a decision is made.⁸¹² Given that the Anti-monopoly law is aiming at “preventing and curbing monopolistic conducts”⁸¹³... and the term “monopolistic conducts” includes “concentration of business operators that may have the effect of eliminating or restricting competition”⁸¹⁴, “all entities and individuals shall have the

⁸¹⁰ Provisions of the State Council on Thresholds for Prior Notification of Concentrations of Undertakings 2008 a.3.

⁸¹¹ Measures for the Undertaking Concentration Declaration 2009 a.8.

⁸¹² Measures for the Undertaking Concentration Examination 2009 a.3.

⁸¹³ Anti-monopoly Law of P.R.C. a.1.

⁸¹⁴ Anti-monopoly Law of P.R.C. a.3.

right to report to the Ministry of Commerce a suspected failure to legally declare the concentration of business operators”⁸¹⁵. Once the business operators implement the concentration without legal declaration and is confirmed by investigation authorities to reach the threshold of declaration, the business operators shall be fined up to 500,000 RMB and can be ordered to “stop the concentration, to dispose shares or assets, transfer the business or adopt other necessary measures to restore the market situation before the concentration within a time limit”.⁸¹⁶ Consequently, it makes the target company possible to use this as a defence to the hostile raider.

To summarize, it could be seen that raising antitrust issues to relevant authorities may be helpful for a target company in delaying a hostile bidder, and make time for finding a white knight or to strive for a higher premium - but it is also risky as it can terminate a takeover. Moreover, the use of this tactic may have different effects in different markets because China, the UK, and the US have different authority structures which can be interfered with by government at different levels. In addition, it is argued that antitrust issues could be problematic for judges or legal practitioners as they need “more thorough and delicate analysis of economic issues than had ever been needed in resolving questions under the [other] branches of law”.⁸¹⁷ Even if a target company really wanted to terminate a hostile takeover with the help of the

⁸¹⁵ Interim Measures for Investigating and Handling Failure to Legally Declare the Concentration of Business Operators 2011 a.4.

⁸¹⁶ Interim Measures for Investigating and Handling Failure to Legally Declare the Concentration of Business Operators 2011 a.13.

⁸¹⁷ *William Letwin, Law and Economic Policy in America: The Evolution of the Sherman Antitrust Act* (University of Chicago Press 1981) 143.

relevant authority, this is dependant on the decision made by the judges or officers in those authorities. If officers are not professional enough to deal with the relevant issues, thus could be time-consuming, or the decision will not be what the target expected. There may be issues for the target or the bidder if either is not satisfied with the decision - but this will cost them more time, and during that period, no one can guarantee that they may not miss other investment opportunities. Thus, the more professional and experienced the regulators or officers are, the better such an antitrust system will work, especially in China's market.

The following section will introduce a notable case in China they involved anti-trust investigation. In this case, the anti-trust investigation worked well as a takeover defence against a hostile raider even though it was not a pro-active measure.

3) Case study

Since antimonopoly investigation is not voluntary in China, a target company may have more time to fight against a hostile raider. A recent case illustrates this.

In the case introduced in Chapter 4, when discussing the Pac-man tactic, of Men's Wearhouse vs. Jos. A Bank, the target company, Men's Wearhouse raised antitrust concerns regarding the offer with the Federal Trade Commission and successfully got more time to further prepare its Pac-man defence. When the target successfully changed its role to a bidder, the original bidder used the same tactic, raising antitrust

concerns in a further attempt to stop the takeover. However, the FTC's investigation did not stop that merger and the takeover was successfully completed.⁸¹⁸

In December 2011, Sinopec and ENN Energy joined together to announce a hostile offer for 50.1 per cent of the shares in China Gas at a price of 3.5HKD per share.⁸¹⁹ However, after almost a year, Sinopec and ENN Energy gave up this takeover because of the lack of approval from the relevant authorities. During the interim 10 months, the Chinese anti-monopoly authorities, at that time, the MOFCOM and the NDRC, conducted investigations into this takeover. This takeover involved two parties, which were State-Owned Enterprises; it is quite common for this kind of hostile takeover to end in failure if it was not initiated according to the state's will.⁸²⁰ Until these two raiders made an official announcement that they would give up this hostile takeover, the approval of these authorities was not given. Moreover, this anti-monopoly investigation gave sufficient time for China Gas to take other actions to defend against the hostile raider, even if the anti-monopoly investigation was clear.⁸²¹ China Gas found allies to save its control over the company: Beijing Enterprises Group raised its holding of shares from 15 per cent to 18 per cent of

⁸¹⁸ Brent Kendall and Dana Mattioli, 'FTC Approves Merger Between Men's Wearhouse, Jos. A. Bank: Commission Grants Antitrust Clearance to the Planned Merger of Men's Clothiers' *The Wall Street Journal Business Section* (30 May 2014).

⁸¹⁹ Yuequn Li, 'ENN Energy and Sinopec Join to Takeover China Gas' (14 December 2011) <http://www.sinopecgroup.com/group/xwzx/mtbd/20111214/news_20111214_310180000000.shtml> accessed 14 May 2014.

⁸²⁰ 'Lex Column: Hostile Takeovers With Chinese Characters' *Financial Times*, (9 July 2012) <<http://m.ftchinese.com/story/001045405>> accessed 14 May 2014.

⁸²¹ Li He, 'Sinopec and ENN Energy Give Up Taking Over China Gas' *Financial Times*, (16 October 2012) <<http://www.ftchinese.com/story/001046993>> accessed 14 May 2014.

China Gas's total shares, and Fortune Oil also raised the percentage of its holding of shares of China Gas. Consequently, the total shares held by the white knights of China Gas were over 50 per cent, which made Sinopec and ENN Energy's takeover impossible.⁸²²

In this case, the anti-trust investigation was not initiated at the request of the target company due the compulsory merger control policy in China. However, anti-trust issues did give the target more time to seek a white knight and saved the existing management team. This case also functions as a sign to other companies that an anti-trust investigation can help defend against a hostile takeover even if the takeover is judged unlikely to have a negative effect on competition. Thus it can be understood why scholars have started to focus on discussing anti-trust law to defend against hostile raiders in an era where foreign investments are flowing into China.

4) Discussion and summary

This case shows that anti-trust investigation may be time-consuming but it can work very well in defending against a hostile takeover. Thus, China's mandatory anti-trust investigation may also be helpful, to a certain extent.

Conversely, the UK's voluntary anti-monopoly rules could prove risky for companies in respect of takeover activity if the relevant authorities do not approve this merger after the merger has completed. Since the result of a failed competition investigation

⁸²² 'Lex Column: Hostile Takeovers With Chinese Characters' Financial Times, (9 July 2012) <<http://m.ftchinese.com/story/001045405>> accessed 14 May 2014.

may “force the disposal of a business if the merger is prohibited”,⁸²³ once this decision is made, the merged company - especially shareholders, whose shares are consequently devalued - could incur huge losses. The American mandatory merger controls could negate this risk to the companies but is time consuming: merger investigations take time. For China, where the market is young, the voluntary style does not fit very well because the risk is too high for companies if the takeover activity is found to have monopoly issues when the takeover activity has successfully ended. If China used voluntary notification, less-experienced listed companies would bear the risk of failing in post-merger investigations and terminate mergers after much preparation. If a monopoly judgement were made by relevant authorities, the losses to both the target and bidding companies would be tremendous. Thus it is better for China to have a relatively safe way of regulating antitrust issues through its mandatory antitrust investigation system. This control system could also be more helpful for listed companies to prevent losses after a merger has ended.

China is different from the US and UK, with a more concentrated power in the hands of the government - but it should not be judged to be wrong just because of its unique mode of market control. The Chinese government has a large amount of capital invested in State-owned enterprises, through which capital can be indirectly transferred to other listed companies in China. That is to say, the government could be

⁸²³ CMA, ‘Mergers: How to notify the CMA of a merger’ (31 March 2014)

<<https://www.gov.uk/mergers-how-to-notify-the-cma-of-a-merger#benefits-and-risks-of-your-decision>> accessed 24 May 2014.

described as something of a monopolist within the market, despite it acting as the regulator to provide remedies to protect against monopolies.

SOEs are directly controlled by the government; some of the listed companies are indirectly controlled by the government - we cannot tell the percentage of the indirectly controlled companies. However, it can be presumed that “indirectly controlled listed companies” are not exactly controlled by the government and are just means for investments by the government to maximise the premium of its available investment capital. Some business areas are controlled by the state, but those areas, such as the electricity, oil, and steel industries, are crucial for the national interest and people’s livelihoods, and it is not helpful to fully open these to private companies to invest in. These should at least be controlled by the government during the period during which China is still developing her market. Thus, it is sensible and to some extent a must for the government to act as a monopolist in those industries. As for the rest of the industries that are directly or indirectly invested in by the government, it is impossible to find out how much capital was invested by the government and in which area because the data are too large. There is also no evidence to prove that these invested companies are indirectly controlled by the government.

China’s market reform is continuing, and China finished the second round of SOE reform in 2013, with a modern corporate system now established.⁸²⁴ From 2014,

⁸²⁴ ‘Di Er Lun Guoqi Gaige: Jianli Xiandai Qiye Zhidu dao "Guo Zi Wei" Shidai [The Second Round of SOE Reform: Establishing Modern Corporation Regime to "SASAC" Era]’ *IFeng Finance*, (16

China has allowed private capital invested into some SOEs to develop mixed ownership and new SOEs will hopefully be more active in the market.⁸²⁵ The route of reform of China's market may be distinct from other markets in the world, but the final destination is unlikely to be very different. China is aiming to create a more effective market but cannot make it as free as the western markets in a short time. Hence, there are certain areas that need to be relatively concentrated and mainly controlled – not totally controlled, like the SOEs; some others should be more competitive.⁸²⁶ Anti-trust legislation could be more tolerant regarding mergers between those companies and between some small companies in competitive areas and be stricter with mergers between larger companies, especially SOEs, in that power might already in hands of those companies, making the possibility of monopoly higher.

Anti-trust issues should be considered carefully because success of proving the existence of problems within a takeover regarding competition issues will terminate the takeover in the end: even if the hostile raider offered a much higher premium which the shareholders would like to take they cannot change the situation. This

December 2013) <http://finance.ifeng.com/a/20131216/11282633_0.shtml> accessed 22 August 2014.

⁸²⁵ Fengyu Ai, 'Xi Jinping Tan Suoyouzhizhi Gaige: Guoqi Minqi He De Lai Caineng Hun De Hao [Xi Jinping Discusses the SOE Reform: The SOE and the Private Companies Could Be Mixed Better If They are Mixable]' *China Economics*, (19 August 2014) <http://www.ce.cn/xwzx/gnsz/szyw/201408/19/t20140819_3382163.shtml> accessed 25 August 2014.

⁸²⁶ Peking University Research Group of Guanghua School of Management, Listed Companies' Takeover Defence Tactics and Relevant Regulations in China [Zhongguo Shangshi Gongsi de Fan Shougou Cuoshi jiqi Guizhi] (Fudan Press 2003) 172.

takeover defensive measure should therefore not be used too frequently in case the target's shareholders miss an attractive offer. In any case, there are alternative options to defend against a hostile raider taking over the target company if the shareholders in the target company are not satisfied by the premium offered; they need not rely on anti-trust law alone.

As pointed out by the US Supreme Court, anti-trust legislation has the characteristics of generality and adaptability, thus judges will have more discretionary power over anti-trust cases.⁸²⁷ Accordingly, the implementation of antimonopoly law could be very complicated in practice. Meanwhile, in the contemporary world, takeover activities are thought to be helpful to the development of the market, and thus too many restrictions on takeover activities may have a negative effect on the market. All the efforts put into anti-trust regulations are for the purpose of solving monopoly issues and providing a competitive market for consumers. But China would be wise not to allow administrative powers to interfere into economic activities too much in this respect, especially when it does not have sufficient supporting protection for market players or experienced staff to help.

⁸²⁷ *Appalachian Coals, Inc. v. United States*, 288 US 344, 360 (1933) and Department of Treaty and Law of MOFCOM, 'Features of Antimonopoly Law' (*Ministry of Commerce of the PRC Department of Treaty and Law*, 27 April 2005)
<<http://tfs.mofcom.gov.cn/article/dzgg/gwyxx/200504/20050400081089.shtml>> accessed 14 May 2014.

5. Why the UK's system of takeover regulation is more appropriate for China

In order to establish which regulatory system is better for China, the attitude towards hostile takeovers should be considered. That is to say, what system China will adopt in regulating takeover activities. As discussed earlier, China's adoption of a UK-style takeover regulatory system may be prudent as China believes an increase in takeover activities would bring some benefits to China's market and help to promote its development.⁸²⁸ Encouraging takeover activities may push competition in the market to strengthen the best companies, and eliminate the worst. In this case, a takeover-friendly legislation system would be a wise choice. In addition, research has shown that takeover activities can push the improvement of listed companies' corporate governance and increase the value of listed companies.⁸²⁹ Moreover, the stock market is an ideal source of finance for these moves and could help listed companies get enough capital for further company development.

In considering why China did not choose a US-style director-friendly style regulatory system, it should be remembered that the US had an attractive market first, then improved background regulation, after which takeover activities and then takeover defences emerged. Everything happened gradually and at each stage there were

⁸²⁸ Jinping Xi, 'Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform' (The Third Plenary Session of the 18th CPC Central Committee) Pt.3.

⁸²⁹ Yao Lu, 'Research of the Impact on the Value of China's Listed Companies by Activating Takeover Market' (2010) 7 Finance Research 144, 157.

discussions and improvements regarding relevant regulations. China has a young market, but market players have already realised the benefits of takeover activities, influenced by successful experiences in the more advanced western markets. Yet China does not have sufficient regulations to prevent or resolve many issues that may arise during the takeover process. Consequently, if takeover defensive measures are also legalised in China, the result and experience is unlikely to be comparable to that of the US without extant supportive factors in the market.

As mentioned in the previous chapter, most of China's commercial legislation is based on the experienced western legislative systems, yet different regulatory systems are established with different intentions based on specific market conditions. That is to say, the degree of government intervention may be different between regulatory systems. Thus, the first issue for Chinese legislators to consider could be the degree of government intervention desired, after which they could choose a regulatory system to take reference from.

According to research on the theory of government intervention, China's market is not as sound as the western markets and it is still in a state of economic transformation.⁸³⁰ There are other important issues which cannot be ignored, too: currently, during this transformation of China's market, companies are taking many objections of Chinese government such as the economic development, employment

⁸³⁰ Justin Yifu Lin, Fang Cai and Zhou Li, 'Competition, Policy Burdens, and State-Owned Enterprise Reform' (1998) 88 *The American Economic Review* 422, 427

issues, and economic stability hence the companies' business activities could not be totally free from the intervention of the government in China.⁸³¹ Thus the range of government intervention could be wider in China to help finish the economic transformation in a smooth way.⁸³²

It is also pointed out that the legal protection of shareholders is relatively weak in China because of its corporate governance structure, and merger activities could help with resource reallocation in China's market to adjust industrial structures in order to help make the market more effective. Therefore, the power of choosing whether to adopt takeover defensive measures should be in the hand of the shareholders.⁸³³

In the US, there is a relatively sound supervisory system of the market even if the takeover defensive regulatory system seems to be a director-friendly one, and shareholders can be protected through other supervisory means. For example, almost every state in the US has a responsibility to supervise takeover activities and has powers available to protect market players through litigation.⁸³⁴ Other regulations including anti-trust law, supervisory regulations regarding the stock market and the

⁸³¹ Ibid 427.

⁸³² Rui Tao, *Research on M&A Problems of Chinese Enterprises During Transitional Period - Taking the Steel Industry as An Example* (China Economic Publishing House 2013) 38.

⁸³³ Peking University Research Group of Guanhua School of Management, 'Research Report with Shanghai Security Exchange: Takeover Defences of Companies Need to be Regulated [Shangzheng Lianhe Yanjiu Jihua Baogao: Gongsu Fan Shougou Xu Guifan]' (*Shanghai Securities News*, 2003) <<http://www.people.com.cn/GB/jinji/35/159/20030422/977513.html>> accessed 16 May 2014.

⁸³⁴ Xin Zhang, 'Shangshi Gongsu Shougou de Lifa he Jianguan -- Wo'men Wei Shenme Buneng Caiqu Meiguo Moshi [Takeover and Legislative Regulation: Why the American Approach is Disfavoured]' (2003) 8 *Securities Market Herald* 1, 8.

professional self-restriction of shareholders in listed companies and of other market players, such as investment banks. Judges can also assist in establishing precedent when dealing with the disputes around takeovers.⁸³⁵ Thanks to these mechanisms and regulations, the SEC can protect the shareholders by considering minority and majority shareholders relatively equal in practice, even if the SEC cannot provide a mandatory offer requirement in the market. Also, due to the fiduciary duties of directors and different requirements of different state regulations in the US, the effect of the US takeover regulation in practise could be similar to the UK's regulatory system in respect of a tender offer requirement. For example, in Pennsylvania, there is a control share cash-out provision, which regulates that once the bidder gains more than 20 per cent of shares of the company, the other shareholders have the right to ask the bidder to purchase their shares at a fair price.⁸³⁶

Conversely, in China, the supervisory framework is not as sound, and the relevant regulations are not sufficient to deal with the issues China would face in adopting a US-style regulatory system. There is also the fact that, in China's market, the number of listed companies is small, which makes takeover activities livelier. Previously, listing on the Chinese market was very complicated, with multiple examinations and approvals required by supervisory departments. As a result, companies already listed on the market could be seen as attractive targets, no matter how they have performed,

⁸³⁵ Ibid 1.

⁸³⁶ 2010 Pennsylvania Code Title 15 – Corporations and Unincorporated Associations Ch. 25 Subchapter E § 2543 and § 2546.

as companies that may not be qualified to list but yet want to engage with the market might wish to acquire them.⁸³⁷ Listed companies acquired for use in this way are called “shell companies”, and potential bidders can skip complicated approval procedures and be listed directly through their acquisition. If takeover defensive measures are legalised in the Chinese market, this will increase the difficulty for bidders seeking to acquire these companies and may cause problems in selling a “shell” company at an unreasonable price. From this perspective, it could be argued that the market would benefit from a takeover-friendly regulatory system, making a UK-style system the better choice.

That said, since China has launched a new round of market reform and indicated it will simplify the approval procedure for listing,⁸³⁸ the attractiveness of “shells” might be adversely affected and the price of such companies might be reduced. This reform may help with the increase of numbers of listed companies but is not likely to have a negative impact on the frequency of takeover activities. On the contrary, this reform might push takeover activities to make the market more active because listing is easier than before, reducing the cost of finance in the market.

⁸³⁷ Zhixue Li, *Gongsi Binggou yu Zhengfu Jianguan Zhengce Yanjiu [Research on Corporate Mergers and Acquisitions and Supervisory Policy of the Government]* (Economy & Management Publishing House 2012) 11.

⁸³⁸ Jinping Xi, ‘Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform’ (The Third Plenary Session of the 18th CPC Central Committee), available at http://www.china.org.cn/china/third_plenary_session/2014-01/16/content_31212602.htm, accessed 10 July 2015.

It is also worth noting that China is seeking reforms to allow for “mixed ownership”, which may reduce (but not eliminate) the controlling power of the state in the market. After such a reform, SOEs could become more independent from the state; if so, the availability of harsh measures for defending against hostile takeover would not be desirable as it may prevent private investors making offers to those companies. If China succeeds in finishing this reform, the mixed shareholder structure could help solving the “Yi Gu Du Da” [highly concentrated shareholding structure] problem and might align China further with the UK-style shareholder-friendly system. Whatever the results of this reform, the UK’s regulatory system is a better choice for China. As it is discussed in the thesis that the existence of China’s SOEs make China’s market unique from the western countries, but the SOEs could also be viewed as an institutional investor which can make better choice of accepting an offer or not. It is just like the UK’s market, which also has a lot of institutional investors. Since the UK’s regulating system would fit China’s market better than the US’s. Also, China has CSRC to regulate market activities, which is directed by the State Council. With this background, the CSRC could have more power than an independent Panel in the UK because it could be seen as part of the state authorities. At the same time, it could be more efficient than courts in the US, because suing in courts would be time-consuming. However, it seems unrealistic to make the CSRC independent from the government, and in this thesis it argues that there might be no need for making it so. Because if the regulation system is sound and clear, CSRC could just follow the rules to solve takeover related issues, it is not fair to say that CSRC cannot solve

market affairs fairly just because it is a state authority. Likewise, it is not right to say that the Panel would be fairly in supervising takeover activities just because it is an independent body. It could be possible that if the regulation system is sound, it does not really matter that the supervisory body is a Panel, the courts, or a state authority.

6. Principles should be followed to regulate takeover defence tactics

It could be argued that there is no market like the stock market so dependent on supportive legislation, and that is because the stock market has an important position for the development of a nation's economy.⁸³⁹ At the same time, since products on stock market are virtual, highly risky, and speculative, regulating market activities is extremely complicated. However, without sound and proper legislative support, the stock market cannot function or develop properly. Thus, a suitable legislative system is a key point to guaranteeing market development. The importance of a good legislative background to support the improvement of corporate governance should not be forgotten, either. Hence, China should adhere to certain principles when regulating takeover defensive tactics.

1) Fair and equal treatment of shareholders

The first principle to be discussed is the treatment of shareholders in China's market. Ideally, there would be totally equal treatment for all shareholders within a company to show the equity of economic rules. However, it seems impossible that an immature

⁸³⁹ Liwen Qing, *Research on Supervision Related Issues of Listed Companies in Our Country* (Masters Thesis, Sichuan Academy of Social Science April 2012) 11.

market such as China's will treat every shareholder at an equal level, given its imperfect regulation and supervision systems' support. Moreover, as there are a certain amount of non-tradable shares in China's market, it is hard to ensure that tradable shareholders are treated equally to those non-tradable shareholders because their shares operate under different conditions. Additionally, even though it is forecast that there will be a free market that is as, or even better than those that currently exist in more advanced countries, this is only the prediction of some scholars. At present, China's market is still reforming, with lots of takeover agreements negotiated and final decisions taken by majority shareholders, without the consent of minority shareholders.⁸⁴⁰ However, since it is likely that state owned shares will stay in the market for a long time and that China will not change the administration and management of those shares, there will always be critics of the unfair treatment this exposes other market players. Only if China can achieve the goal of "managing capital only not the directors",⁸⁴¹ will there be the possibility that SOEs and non-SOEs will be equal in the market, as the interference of government would be limited and the treatment of shareholders would be fairer.

⁸⁴⁰ Changshi Zhou, *Zhengfu Kongzhi Xia de Gongsi Binggou Yanjiu Lilun yu Jingyan Shuju [Research on Corporate Takeovers Under Government's Control: Theory and Experience Data]* (Economic Science Press 2009) 193.

⁸⁴¹ Jinping Xi, 'Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform' (The Third Plenary Session of the 18th CPC Central Committee) states that the goal of changing state-owned capital's managing mode from managing the directors to managing the capital only, in order to make the market fairer and more competitive.

Thus, under current circumstance in China, providing all shareholders with equal treatment is unrealistic. However, the reform in China is continuing to move towards an advanced and free market, as it is helpful for the development for China's economy. In the UK (and in most EU member countries), regulators are trying to ensure all the shareholders are treated equally, in order to make sure the minority shareholders' rights are not infringed.⁸⁴² This is the same in the US, where legislators also try to treat all the shareholders fairly to guarantee the market's fairness.⁸⁴³ As market fairness is a key factor in ensuring the healthy development of China's market, if China is to develop a sound legislative system, it should also follow the principle of existing free markets to treat all shareholders equally. Especially in respect of takeover activity, minority shareholders can be vulnerable if only limited protection is provided for them. Different takeover defence regulatory systems have different levels of protection. If decision-making power is given to shareholders, as in the UK system, and a mandatory offer rule is established, shareholders could have strong powers in takeover activities. If decision-making power is delegated to the directors, as in the US system, more supporting regulation will be required to ensure all shareholders are treated equally because of the high possibility of information asymmetry between directors and the shareholders, and between majority and minority shareholders. Although the UK and the US have both fallen short, at times,

⁸⁴² Jonathan Mukwiri, 'Takeovers and Incidental Protection of Minority Shareholders' (2013) 3 ECFR 432, 460.

⁸⁴³ James D. Cox, 'Equal Treatment for Shareholders: An Essay' (1997) 19 Cardozo Law Review 615, 616.

in protecting minority shareholders and ensuring market fairness, China's market has even more defects in that respect. The best way for China to proceed would be to choose a takeover regulatory system that can provide more protection to shareholders directly, without too many additional regulations or supervisory support. Thus, the UK's takeover regulatory system, with its principle of equal treatment to all the shareholders seems the reasonable and prudent choice for China to emulate.

The US-style system, in contrast, requires a sounder market to facilitate the protection of market players, a market that China does not have in the US's there are certain takeover defensive measures which treat the majority and minority shareholders in different ways. For example, the poison pill, a successful and widely used takeover defensive tactic in the US, seeks to confer more rights to preferred shares which normal shareholders do not have. This gives the holders of preferred shares more power over the control of their company than the holders of normal shares as the rights conferred by preferred shares could be exercised in certain votes regarding a hostile takeover. Even the inventor of the poison pill, Martin Lipton, has said that the intention of the pills' creation was not to treat shareholders differentially, but to give the board of directors sufficient time to decide whether to accept an offer or not, in response to the significant increase in activity that occurred in the 1980s.⁸⁴⁴ The success of poison pills in the US market did not arise only thanks to the effectiveness

⁸⁴⁴ Shira Ovide, 'Marty Lipton: Why I Invented the Poison Pill' (The Wall Street Journal, December 29, 2010) <<http://blogs.wsj.com/deals/2010/12/29/marty-lipton-why-i-invented-the-poison-pill/>> accessed 10 August 2013.

of this tactic itself, but also because of appropriate supervision regulations and the professionalism of market players. At present, China is at similar stage as the US market was in the 1980s, when hostile takeover activities started to emerge, but unlike the case in the US, Chinese market players are not as experienced, and China's relevant regulations are not as sound as that which existed in the US at that time either. Thus it would be extremely risky for China to adopt a US-style takeover regulatory system. That said, according to the newly issued Administrative Measures of Preferred Shares Experimental Units in 2014, it seems China is seeking a takeover regulatory system with both the UK's takeover regulation style and certain features of US regulation. China's system provides that, in most cases, preferred shares do not confer voting rights, to ensure market fairness - but it is also trialling the use of poison pills in the market with the restrictions as discussed in Chapter 5. These regulations are based on the principles of protecting market fairness as well as promoting market effectiveness.⁸⁴⁵

2) Sufficient supervision and market effectiveness

A sound market requires a sound supervision system to support its running, and contemporary China cannot be said to have a sound supervision system. China's market is mainly supervised by the CSRC and under its supervision, stock exchanges

⁸⁴⁵ Mingfang Zhu, 'Youxian Gu Shidian Shi Woguo Ziben Shichang Fazhan de Zhongyao Yi Bu [Experimental Units of Preferred Shares are Key Steps of the Development of China's Market]' (2014) 5 Development Research 23, 23.

and relevant securities associations play helping roles. However, only the CSRC and stock exchanges can supervise all takeover activities in the market.⁸⁴⁶

It may not be the right time for China to allow the use of all takeover defensive measures since these measures have, elsewhere, evolved alongside the development of the market. The poison pill, for example, now has the additional (potential) function of protecting net operating losses, yet China is still at the initial stage of perfecting its market, and if poison pills are legalised, this could be problematic for the market because supervisory legislation needs time to be revised. Currently, preferred shares are encouraged in China and allowing use of poison pills would require legislation such as the Accounting and financial reports regulations to be improved as soon as possible, in order to cooperate with the new facility.⁸⁴⁷ Moreover, supervisory teams lack the necessary experience to even deal with takeover defensive measures as regards their original function, so dealing with even more evolved functions of the defensive tactics could be especially challenging. Furthermore, a hostile takeover requires lots of capital to fund and may involve loans from the banks - risk assessments and relevant banking laws might also pose a problem.

⁸⁴⁶ Liwen Qing, 'Research on Supervision Related Issues of Listed Companies in Our Country' (Masters Thesis, Sichuan Academy of Social Science April 2012) 13.

⁸⁴⁷ Mingfang Zhu, 'Youxian Gu Shidian Shi Woguo Ziben Shichang Fazhan de Zhongyao Yi Bu [Experimental Units of Preferred Shares are Key Steps of the Development of China's Market]' (2014) 5 Development Research 23, 24.

More importantly, the market's effectiveness could be affected by governmental intervention. Thus the degree of the government intervention is an issue in considering takeover defence regulations. According to Tian's research on major merger activities in China's market between 2005 and 2010, the effective allocation of resources in the market has increased since 2005, but the government's intervention had some negative effects on that growth, and the degree of those negative effects increased with higher levels of government interference.⁸⁴⁸

3) The information disclosure principle

Information disclosure mainly involves the following elements: First, the issue of disclosure relative to shareholding. Disclosure of shareholding must take place when the shares that an investor holds in a listed company reaches 5 per cent. After reaching this particular proportion, timely disclosure of this information is required, as well as every time that shareholder's proportion of shareholding increases or decreases above 5 per cent. However, if a hostile bidder does not fulfil this obligation and secretly buys more than 5 per cent of targets shares, this increases the possibility of success of their takeover action and places the target company in an unfavourable situation. Called the first case of mergers and acquisitions among China's listed

⁸⁴⁸ However, research shows that, in China, the effectiveness of merger activities intervened in by provincial governments is higher than those intervened in by municipal governments. See Manwen Tian, 'The Evaluation of Government Intervention, the Change of Ultimate Controlling Shareholder and the Effects of Mergers and Acquisitions' (2012) 6 Finance and Economics 18, 25.

companies, "Bao Yan storm" is the best-case description of a violation of information disclosure obligation.⁸⁴⁹

As mentioned, the US takeover regulative system does not have a mandatory bid rule, which indicates that the system is not a shareholder-friendly one, affording less protection to minority shareholders. However, shareholders still can obtain sufficient protections from the SEC supervisory system and states' supervisory systems; the key factor in successfully supervising the market is the US' information disclosure system.⁸⁵⁰ According to Zhang's research, the main body in charge of supervising M&A activities is the Division of Corporate Finance, and there are special counsel and rotating attorneys in that department who review relevant documents of M&A activities. These professionals review the adequacy of relevant information disclosures and present a "comments letter" to give their opinions on whether this takeover would harm any relevant person's rights, and especially whether the information disclosed could mislead certain people, and whether companies involved in the takeover activity did not obey the rules on revealing certain details of the takeover activity.

4) Possible problems and China's regulatory system

⁸⁴⁹ Hongcai Xu (ed) *Zhongguo Ziben Yuning Jingdian Anli Chuangxin Pian [Typical Cases of Capital Operation in China - Creation Part]* (Tsinghua University Press 2005), 154.

⁸⁵⁰ Xin Zhang, 'Shangshi Gongsi Shougou de Lifa he Jianguan -- Wo'men Wei Shenme Buneng Caiqu Meiguo Moshi [Takeover and Legislative Regulation: Why the American Approach is Disfavoured]' (2003) 8 Securities Market Herald 1, 8.

In China, the stock market is still in its infancy and so should learn from the experience of mature western markets, even if the size of China's market is larger and has improved in recent years. Ke Deng, the news spokesman for CSRC approved that point officially, on 10 January 2014.⁸⁵¹ There are still some areas in which China's market needs to improve, however, and in an immature market, the regulatory system cannot be advanced without at least moderate government intervention.

Any takeover activity can be seen as the "survival of the fittest", because it eliminates weaker businesses to optimise the allocation of resources – yet it also promotes the concentration of resources, which may result in a monopoly. Making laws is a tool for the government to intervene in market activities.⁸⁵² It can be a challenge for regulators to strike a balance between fairness and efficiency, and even harder still to decide on an appropriate degree of government intervention in merger activities in the market.⁸⁵³

There are different features of M&A activities in China and the western countries. Firstly, most Chinese takeover activities in recent years have been pushed by the government. Most takeover deals were done directly by signing agreements between the bidder and the target without any market activity. However, in the western

⁸⁵¹ --, 'ESOP is Being Studied' (*Securities Daily*, 11 January 2014)

<<http://finance.eastday.com/c9/2014/0111/2553526514.html>> accessed 12 August 2014.

⁸⁵² Hui Yu, 'Zhengfu Guanzhi yu Xingzheng Gaige [The Government's Intervention and the Reform of Administration]' (1997) 5 *China Industrial Economics* 29, 32.

⁸⁵³ Rui Tao, *Research on M&A Problems of Chinese Enterprises During Transitional Period - Taking the Steel Industry as An Example* (China Economic Publishing House 2013) 38.

countries, most takeover offers took place within the market and were prompted by the power of the market itself.⁸⁵⁴ Agencies in China's market that might help to facilitate a successful takeover case, such as an investment bank, do not have sufficient experience in dealing with relevant takeovers, reflecting the infancy of China's development in dealing with takeover activities.⁸⁵⁵

It is also known that the stock market is a good place to obtain finance, market share and margins, or improve the performance of corporate governance,⁸⁵⁶ so the motivation of the companies both in China and western countries could be seen to be similar. That said, there is one key factor that is totally different in China, and that is the intervention of the government in the market. The Chinese government has, historically, pushed profit-making companies to merge with loss-making companies in order to achieve political aims. Furthermore, the government has also taken advantage of the market's financing benefits and tried to make those companies that want to list on the market to merge with a loss-making state-owned company as a requirement to be listed.⁸⁵⁷ This has been criticized by scholars for years, and there many examples that illustrate how the government's intervention went too far and should have been limited in order to let the market itself decide which company

⁸⁵⁴ Zhixue Li, *Gongsi Binggou yu Zhengfu Jianguan Zhengce Yanjiu* [Research on Corporate Mergers and Acquisitions and Supervisory Policy of the Government] (Economy & Management Publishing House 2012) 7.

⁸⁵⁵ Ibid 7.

⁸⁵⁶ Ibid 8-10.

⁸⁵⁷ Ibid 11. This is called "Lalang Pei", which is a kind of matching system in China. It is directed by the government to pair a profit-making company with a loss-making company and make them merge in order to save a loss-making SOE.

should survive.⁸⁵⁸ Even if the government intended to integrate the resources owned by SOEs and reform the SOEs' structures, changes should not go against market rules. Thus it could be said that the first and most important principle the regulators should follow is to let the market have its say and to limit the government's power to a macro level.

Moreover, moderate government intervention means that the government can instead provide the market with a sound supervision system to ensure all the issues could be resolved in a reasonable way, and to provide market players with sufficient protection by law.

a. Protection of all shareholders

The officers dealing with M&A affairs in the Division of Corporate Finance are professionals. This is a good guarantee of the effectiveness of the legitimacy of these

⁸⁵⁸ The most significant case to be seen as a failure was the merger between Sinotrans and CSC Holdings, which was led by the SASAC. This merger began in 2007 and took 7 years. The merger did not benefit any company but caused CSC Holding to incur continued losses. More details can be found in Juanjuan Chen (ed), 'ST Changyou Shuailuo Yangben, Lalang Pei Zhi Baiju [Sample of ST Changyou's Failure, Lalang Pei Led to this Failure]' *china.com.cn*, (18 March 2014) <<http://finance.china.com.cn/stock/ssgs/20140318/2265599.shtml>> accessed 12 August 2014. And more articles supporting this idea could be found in 'Zengqinghong Yiyu Jingren: Zhengfu Lalang Pei Xiangying Haozhao Que Shangdang (2)' *China Business News*, (21 August 2013) <http://www.s1979.com/caijing/gongsi/201310/21104108021_2.shtml> accessed 12 August 2014 and 'Bimian Danchun "Lalang Pei" Guoqi Shichanghua Chongzu Zai Tisu' *Securities Daily*, (11 February 2014) <<http://www.s1979.com/caijing/guonei/201402/11113706911.shtml>> accessed 12 August 2014. Li's research has also supported the idea that the government should not intervene in the market too much. See Zhixue Li, *Gongsi Binggou yu Zhengfu Jianguan Zhengce Yanjiu* [Research on Corporate Mergers and Acquisitions and Supervisory Policy of the Government] (Economy & Management Publishing House 2012) 32-34.

activities. However, it seems impossible that the contemporary Chinese supervisory departments will have this kind of professional background and the requisite information disclosure supervision of takeover activities to protect all the shareholders in the market.

First, inadequate or unfair information disclosure can cause the loss of investments from shareholders. According to the Administrative Measures On Acquisition Of Listed Companies, regulations regarding the information disclosure of target companies (i.e., the regulations for obligations of the directors of target companies regarding information disclosure) are not sufficiently explicit. For a listed company in the process of an anti-takeover action, the "acquisition management methods of listed companies" in relation to the procedural issue of information disclosure do not embody the characteristics of timeliness, accuracy and integrity etc.;⁸⁵⁹ because of this, the further enhancement of certain regulations is required. These include, firstly, that during the process of the acquisition of a listed company prior to the contact of the board of target company and the acquirer, if the board of the target company has reason to believe that it is inevitable that their company will be taken over, an

⁸⁵⁹ Administrative Measures On Acquisition Of Listed Companies, a.8 regulates that: "The directors, supervisors and senior managers of a company under takeover shall assume the obligations of devotion and diligence, and shall equally treat all the purchasers that intend to take over the foresaid company. The decisions made and the measures taken by the board of directors of the company under takeover for the takeover shall be beneficial for maintaining the interests of the company and its shareholders, and may not set any improper obstacle to the takeover by misusing its authorities, nor may it provide any means of financial aid to the purchaser by making use of the sources of the company under takeover or damage the legitimate rights and interests of the company under takeover or its shareholders." But there is no further detailed requirement for the directors in the target company to disclose any information such as a possible takeover bid.

anti-takeover strategy should be initiated at the same time, after which the board of the target company should disclose to the shareholders the currently held information, to allow shareholders to be prepared for actions arising during the process of acquisition and defence. Secondly, after the directors of the target company and the acquirer formally discuss the related issues, regardless of whether the board of the target company is for or against the takeover bid or taking related anti-takeover actions, the related information must be accurately disclosed to shareholders of the target company. Thirdly, after the acquirer makes the takeover bid announcement to the target company, the board of the target company should provide the main text or abstract of the announcement to company shareholders. After receipt of the takeover bid, the board of the target company should, within the statutory period, comment on the current takeover bid and include an explanation of whether or not they will seek to take anti-takeover actions. Fourthly, among the information required to be disclosed, target company board members should state whether there is any conflict of interest. Fifthly, opinions of the company's professional consultants regarding the takeover and any anti-takeover defence should be disclosed to shareholders.⁸⁶⁰

Secondly, the protection of shareholders should not only focus on the shareholders of the target company; shareholders in the bidding company should be protected as well. If the rate of failed business after the M&A action increased, the possibility of wealth increase through takeover activities will decline. All shareholders take the risk of a

⁸⁶⁰ Junjie Zhang, 'Research on Legal Issues of Takeover Defense Tactics of the Listed Companies' (Masters Thesis, Sichuan Academy of Social Sciences 2011) 27.

loss of their investments, especially the hostile raider's shareholders, because if they successfully take over a target company, the hostile offer will include certain premiums paid to the target company and the loss to the raider's shareholders will be larger than that experienced by the target company's shareholders. A hostile takeover defence friendly legislative system, as per that of the US, protects companies and increases the failure rate of hostile takeovers. Research has also shown that successful takeover activities did not substantially improve the business performance of 84 listed companies in China between 1999 and 2001.⁸⁶¹ Indeed, Qiu argued that only around 30 per cent of China's M&A activities made some improvement.⁸⁶² Thus, it is possible to argue that low returns after a takeover in China is a reason to support a system that is friendly towards hostile takeover defences.

b. The protection of minority shareholders

There may also be issues regarding the protection of minority shareholders. This issue has been intensely discussed over recent years by many Company Law professionals, because minority shareholders are thought to be vulnerable compared with the majority shareholders due to their relative lack of information and more limited power and ability to supervise the company.⁸⁶³ However, little research considered the

⁸⁶¹ Shanmin Li and others, 'Research on the Listed Companies' M&A Performance and Its Impact Factors' (2004) 9 *World Business* 60, 67.

⁸⁶² Ming Qiu, 'Thoughts about the Improvement of Success Rate of M&A' (2002) 9 *Management World* 146, 147.

⁸⁶³ Xiaofeng Wu, *Research on the Protection of Minority Shareholders in Mergers and Acquisitions [Gongsì Binggou Zhong Shaoshu Gudong Liyi Baohu Zhidu Yanjiu]* (Lawpress China 2008) 47.

protection of minority shareholders during the hostile takeover process. According to Wu, there are two major issues from both the target's and bidder's minority shareholders' points of views: Firstly, in the target company, adopting takeover defensive tactics can bring some risk to the target company due to the possibility of making the wrong decision. If minority shareholders cannot benefit from their shares, these shareholders will have lost opportunities to gain premiums. Further, if the hostile takeover is successful in the end, inappropriate or unsuccessful takeover defensive measures adopted by the management team could also result in the loss of benefits to minority shareholders. Secondly, in the bidder company, if the takeover defence used by the target company resulted in a rise in the premium paid by the bidder company, this will result in the loss of capital from the bidding company that equates to a loss of benefits to the bidder's shareholders.⁸⁶⁴ No one can guarantee a hostile takeover will be successful, and the risk is borne by the shareholders in both parties. As the majority shareholders have more power over the company, (especially in China, where most Chinese companies are controlled by the majority shareholders), minority shareholders shoulder more risk than majority shareholders during the mergers and acquisition process.

7. Summary

China is trying to make its market as free and open as possible in order to catch up economically with the developed countries and the continually developing global

⁸⁶⁴ Ibid 47.

economy. However, current legislation relating to the market is not sufficient nor advanced enough for China's market players to use some of the advanced strategies learned from western markets. However, China has learned from the UK and EU in constructing a relatively conservative takeover defence legislative system to regulate its own market and to ensure most business activities are under control. Most Chinese market players, and even law makers, are not familiar with these tools; in addition, the professional knowledge to deal with the issues that accompany the use of certain hostile takeover defensive measures is absent, meaning that US-style regulations are not currently appropriate for China. However, that does not mean that these tactics should never be allowed; some of the takeover defence tactics, such as the poison pill, can protect the control power of a target company. Legitimising certain takeover defence measures may only be a matter of time and a more open market in China over the coming decades.

China's regulatory system is often criticised in respect of investing too much power in the government and making the market less free than it should be. China's government has undoubtedly reserved many powers for itself to ensure control over the development of its market so as to create a market with 'Chinese' character.

China is, however, aiming to develop a more competitive and effective market in the future, and so it has reformed SOEs in recent years. However, reforming SOEs does not require privatize them completely. Indeed, the on-going SOE reform aims at reforming SOEs' functions to make them work better, and new policies are still in

discussion. A positive result could be expected, and it is highly possible that there will be a freer and more advanced market in China in the future.

After the anti-monopoly law was introduced 6 years ago, the defensive impact of anti-monopoly investigations was noticed by the listed companies and has been discussed by scholars. If legislators bring more advanced defensive takeover measures to the Chinese market, the situation in the market will likely be different: Some defensive measures can prevent the target company from being taken over by hostile raiders in the future, such as the poison pill, and some measures could help gain controlling power back for the target company, such as a white knight. Sufficient remedies will help improve China's market and provide shareholders with the legislative support required to protect their interests. However, as maximising the shareholders' interests is claimed to be the main principle in regulating takeover activities, all legal evaluations of takeover defence regulation should centre on this principle.⁸⁶⁵ But in contemporary China, more factors would be considered while regulating the market such as the development of the market in the long run. Based on the discussion of China's current market situation, it seems it is not yet the right time to legalise all takeover defensive measures. This can be seen from the newly-released Administrative Measures of Preferred Shares Experimental Units (Exposure

⁸⁶⁵ Hong Wu, 'Principles of China's Anti-Takeover Legislation' in Baoshu Wang (ed), *Takeovers of Companies : Law and Practice* (Social Sciences Academic Press (China) 2005) 265.

Drafts)⁸⁶⁶ and Administrative Measures of the Listed Companies' Employee Shareholding Plan (Exposure Drafts⁸⁶⁷), which showed the improvement of the market - but these measures exclude takeover defensive functions. This could be a sign that China is trying to introduce advanced measures adopted from western countries but gradually, so as to give more time for the market to be adapted and for supportive regulations to be improved.

⁸⁶⁶ Administrative Measures of Preferred Shares Experimental Units (Exposure Drafts) . Available at http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201403/t20140321_245908.htm, accessed 1 July 2015.

⁸⁶⁷ Administrative Measures of the Listed Companies' Employee Shareholding Plan (Exposure Drafts), available at <https://www.google.co.uk/webhp?sourceid=chrome-instant&ion=1&espv=2&ie=UTF-8#>, accessed 1 July 2015.

Chapter 8: Conclusion

This thesis, has adopted the perspective that every legislative choice is also a policy choice, with a discernable reason, and that such choices should be made for the better development of the market and the country. The thesis has mapped out a pathway to permit the better understanding of the issues. Thus it has discussed the characteristics of certain markets and their legal frameworks to find out the reasons why certain takeover regulatory systems fit specific markets, introduced the features and usage of each type of takeover defensive measures, determined in which kind of legislative framework and which kind of market each tactic will work, assessed the suitability of each defence in China; analysed the pros and cons of China's takeover market and current development of the market, and predicted which takeover regulatory system is better for China now and how it may be in the future.

This thesis introduced the background of the development of hostile takeovers from an historical point of view, and the legislative principles of regulating takeover defence strategies in two advanced markets: those of the UK and the US. It analysed important factors, including their legal frameworks, the development level of their markets, and other social factors, such as the characteristics of their shareholders and regulators' political aims in relation to takeover activities in the market. Different takeover defence regulatory systems reflect different attitudes to takeover activities, and different political choices. Thus, a market preferring more frequent takeover activities should adopt a UK-style shareholder-friendly regulatory system, whilst the

market emphasising the directors' competence to choose may more naturally gravitate towards a US-style director-friendly regulatory system.

Most advanced legal systems are informed partly by other states due to global development and global communication. According to research, commercial laws are easily transplanted across different countries.⁸⁶⁸ At the same time, according to Kahn-Freund, no comparative study of the laws of different countries could ignore the context of these laws, and the "context" could be these countries' different political and social backgrounds.⁸⁶⁹ Thus, when transplanting certain rules to another legal system, rule-makers should always consider the context of each country and assess cultural and political differences. This thesis discusses the cultural and political differences between China and the UK and US, before explaining why China opted to transplant a UK-, rather than US-style takeover defensive regulatory system. However, legislators made some changes to the UK system to fit China's young market. However, China's regulatory system is still improving to facilitate a better market, and it seems that it is becoming a mixed system with features from both the UK and US systems.

Meanwhile, there is much evidence that takeover defences are widely used in the US when they go public.⁸⁷⁰ For example, the social network company Facebook

⁸⁶⁸ Otto Kahn-Freund, 'On Uses and Misuses of Comparative Law' (1974) 37 *The Modern Law Review* 1, 13.

⁸⁶⁹ *Ibid* 13.

⁸⁷⁰ Laura Casares Field and Jonathan M Karpoff, 'Takeover Defenses of IPO Firms' (2002) LVII *The Journal of Finance* 1857.

deployed Dual Class Shares when it listed on the market, similar to other companies, like Google, the New York Times, and Ford.⁸⁷¹ Even some Chinese companies that are listed in the US, such as Sohu⁸⁷² and Alibaba,⁸⁷³ incorporated some takeover defence measures in their articles. It is understandable that, at the time when the markets may collapse, many listed companies would be devalued and attract hostile takeovers, especially in IT and media area, as IT companies may have developed very important technologies and media companies can have a great influence on society. Once these companies are devalued because of the declining market, target companies' shareholders struggle to protect their interests. Thus, takeover defensive measures would be extremely helpful, now and in the future.

However, as this thesis has explained, certain tactics and certain regulatory responses are apt to develop at certain times. That is to say, with different social backgrounds in different markets, there will be certain corresponding rules drawn up so as to accommodate this. For example, the US developed its market very early and there were more household investors at first, and other shareholders that did not have a large percentage of shares and did not trust majority shareholders to make vital

⁸⁷¹ Matt Orsagh, CFA and CIPM, 'Dual-Class Shares: From Google to Alibaba, Is It a Troubling Trend for Investors?' *CFA Institute*, (1 April 2014).

<<http://blogs.cfainstitute.org/marketintegrity/2014/04/01/dual-class-shares-from-google-to-alibaba-is-it-a-troubling-trend-for-investors/>> accessed 12 August 2014.

⁸⁷² This is mentioned in Chapter 5.

⁸⁷³ Matt Orsagh, CFA and CIPM, 'Dual-Class Shares: From Google to Alibaba, Is It a Troubling Trend for Investors?' *CFA Institute*, (1 April 2014).

<<http://blogs.cfainstitute.org/marketintegrity/2014/04/01/dual-class-shares-from-google-to-alibaba-is-it-a-troubling-trend-for-investors/>> accessed 12 August 2014.

decisions for the company. Hence the US chose a director-friendly takeover regulatory system to solve this problem. In the UK, there were more institutional investors in the market before the UK had systematic takeover regulation; rule-makers considered this factor while regulating takeover activities and chose a shareholder-friendly system to make this regulation fit the market better. In practise, this system has worked well in this market. So too, certain social factors and market features were considered before China regulated its market. With the Yigu Duda problem in China's market, if there were a director-friendly system, it is hardly possible the major shareholder would like this system to work.

Each anti-takeover defence measure needs a certain premise to work, such as a dispersed shareholding structure or sound supportive supervisory regulations. Without the correct premise, the defensive tactic may not work as well as intended. For example, for the poison pill to be widely used in China, China would require sounder supervisory support and relevant accounting regulations.

That is not to say defence measures are universally praised. On the contrary, scholars criticise the fact that takeover defence measures may have a negative effect on the share price of a target company, and much research has shown that the price of a target's shares does reduce once the defensive action becomes known to the public, especially if the target is without a white knight. Thus, it could be very risky for China to legalise certain takeover defensive measure in its market. However, research has also shown that the public are accepting of the fact that a combination between

target and bidder could increase shareholders' wealth and has the potential to increase share prices, and that resistance can signal the fact that the target does not have a white knight. Thus, the performance of the target's share price at the moment of releasing takeover-related information can only be seen as a reflection of getting the information and cannot be used to judge the performance of a takeover defence tactic itself.

How China will balance the interests between shareholders and directors, and which system China should go with seems to be a difficult issue. However, 30 years ago, when the US and the UK were at the starting point of developing their regulatory systems, they were also faced with a period of heated discussion between scholars and legislators about who should be given the right to accept a takeover offer. And at that time, the rise in the number of takeover bids pushed the development of their legislative systems. As the market in China has developed much later than that of the western countries, China's market is only now experiencing a similar time as that which the developed countries once went through. There is one important difference, however: the legislative experiences from those western countries may be used as reference by China, which may help it avoid detours and reduce the number of mistakes made in the legislative process.

Thus, Chinese legislators should take reference from the successful western regulatory systems but in accordance with the national conditions in China. Certain changes should be made due to the development gap between China's market and the

western markets. That said, this thesis has not focused on the economic development of the market; it has only focused on the legislative support for the development of the market. Accordingly, it cannot be said what the future market will look like, or what will be changed. Regardless, the market should become more open and free in China in the coming decades, because that is the trend of the development of a society or a market operating in a global context. The legislative system in China must not be too anachronistic or conservative. Indeed, the western style legislative systems were developed in a free market, so introducing some of the more advanced regulations to China could be a shortcut for China to improve the legislation level rapidly.

This thesis has concluded that the UK-style, takeover-friendly regulatory system is a better choice for China. Consequently, Chinese regulators should consider how to make this system fit China's market and make it work well. That is to say, they should consider, amongst other matters how to advance takeover-related competition issues, supportive supervision legislation, and minority shareholders' protection and so on. In addition, if China wishes to introduce specific takeover defensive tactics into its market, it must to research the necessary preconditions in order to predict whether this tactic will work in China and establish what drawbacks the use of this tactic might cause.

The "yigu duda" problem still exists in China's market, and this will influence takeover activities dramatically. As long as the state is the only major shareholder, whether the listed company is a bidder or a target, these takeover activities could be

seen as being conducted and controlled by the government. Moreover, even if China chose the US-style, director-friendly regulatory system, that they cannot get rid of the government's control because the shareholder(s) nominate directors: if directors violated the state's will, they would likely lose their positions. Hence, this problem should be solved in China for the future; it is encouraging that China is already working on it now, as discussed in previous chapters. Thus, it is possible, or even probable, that China will have a freer market in the coming years and that the western market's successful regulation experience may be better learnt and used in China going forward.

To conclude, throughout the discussions presented in this thesis, specific points of view have been argued; these are summarised below:

- (1) The choice of a legislative system is a political decision, so before legislators create regulations, they should consider the market's features and its development direction in order to make it work well.
- (2) Compared with the director-friendly regulatory system of the US, the shareholder-friendly regulatory system of the UK will better-fit China's market as the UK and China share a similarly positive view of takeover activities in that takeover activities are seen to help improve the corporate governance of listed companies and the wider market. Moreover, a system like that of the UK should protect well the interests of Chinese shareholders, as it limits the risk of directors' abuse of power.

- (3) A highly concentrated shareholding structure still exists in China but this is not too serious and, with the continuous reform in China's market, China's market should become more open and modern.
- (4) China's SOEs will play an important role in its market for a long time; it seems impossible that they will all be privatised, and in any case, that would be unnecessary.
- (5) The existence of SOEs is not the reason why all takeover defensive tactics were unavailable in China. On the contrary, if China can successfully finish reform of the SOEs, they could become good market players with sufficient capital back up - and the state should not control all business decisions.
- (6) The newly released preferred stock regulation makes the poison pill defence useable in China and means China's regulation is something of a mix between the styles of both the UK and US. Supportive supervisory legislation, such as improved regulations about director's duties in using these tactics and protections of minority shareholders, needs to be improved to prevent the abuse of poison pills.
- (7) Moderate defensive tactics like the white knight, or the three kinds of parachutes could be safely used in China, but high-risk measures like scorched earth or greenmail payments are not encouraged. Legalising these defensive measures should consider the best interests of the listed companies, and defending a hostile takeover should be in keeping with the principle of protecting shareholders' interests and development of the market.

Also, it could be believed that China's market could be more attractive to the investors, and if takeover defensive tactics could be better deployed it will help to maximise shareholders' interest and promote the development of China's market.

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